Prescience 2015:

Expert Opinions on the Future of Retirement Plans

DIVERSIFIED

Partners in Retirement Solutions

PANEL OF EXPERTS

We would like to thank our Prescience 2015 panel of experts for participating in this survey and for sharing their much valued insight.

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INTRODUCTION

pre•science \'pre-sh(ē-)ən(t)s, 'prē-, -s(ē-)ən(t)s
foreknowledge of events; human anticipation of the course of events; foresight.

About *Prescience*

Diversified's *Prescience 2015: Expert Opinions on the Future of Retirement Plans*, conducted in the first quarter of 2011, is the fourth iteration of a modified Delphi study—a study that uses input from a structured group of experts who share a common interest to make predictions about future trends. The study examines trends in retirement plans with $25 million to $1 billion in assets. Sixty-eight retirement plan experts from 54 organizations answered the 181-question survey. Diversified chose survey participants based on their positions as thought leaders and experienced professionals in the retirement plans business. Because of their involvement with major industry contributors, members of this panel are well-suited to foretell high-level trends that will determine the road ahead for the retirement industry.

Panel participants represent policymakers, trade associations, research organizations, consulting firms, academic institutions, financial professionals, investment management firms, service providers and trade media. The survey participants possess a deep understanding of the retirement plans business and a working knowledge of major markets and providers. The purpose of the study is to present executives responsible for retirement plan management with insights on the industry's future so they can develop and evaluate their organizations' plans and strategies. *Prescience* explores trends in regulations, technology, investments, plan design, participant education and communication for the corporate, not-for-profit healthcare, higher education and Taft-Hartley markets.

About Diversified

Diversified is a leading provider of customized retirement plan administration, participant communication and open architecture investment solutions for mid- to large-sized organizations. The company's expertise covers the entire spectrum of defined benefit and defined contribution plans, including: 401(k) and 403(b) (Traditional and Roth); 457; nonqualified deferred compensation; profit sharing; money purchase; cash balance; and Taft-Hartley plans; and rollover and Roth IRA. Diversified helps two million participants save and invest wisely for and throughout retirement.

Headquartered in Harrison, NY, Diversified's regional offices are located nationwide. To learn more, visit divinvest.com.

Retirement Research Council™

The Retirement Research Council, the market intelligence group at Diversified, is dedicated to:

- Presenting a comprehensive picture of the private retirement plans market
- Providing plan sponsors and their advisors with comprehensive, actionable benchmarking information
- Analyzing trends to assist with strategic evaluation of retirement plans

Drawing on more than 50 years of experience in retirement plans management, the Retirement Research Council periodically assembles experts from all facets of the retirement plans business to evaluate the current and future impact of trends shaping the industry.

EXECUTIVE SUMMARY

Background

Although a great deal of information is available about recent trends affecting the retirement plan management business, there is a dearth of reliable analysis as to future directions. In a fast-changing environment, retirement plan sponsors, providers, consultants and advisors need a clear, forward-looking vision of the retirement plans landscape so they can invest in the development of products, services, systems and processes that will meet the needs of plan sponsors and participants well into the future.

Prescience 2015 delivers this vision. It supplements Diversified's other innovative research, drawing a comprehensive picture of the private retirement plans business today and into the future. These research reports focus on current trends and practices and uncover emerging market developments that could have a profound impact on retirement plans.

Change is in the air

Underpinning a Delphi study like Diversified's *Prescience 2015* is the assumption that the future is predictable within reason. The economic, regulatory, socio-cultural and international environment in which we operated between 2007 and 2010 challenged this basic assumption. Indeed, the period since we fielded our last survey in the second quarter of 2008 *(Prescience 2013)* was marked by a great number of unforeseeable events. Back then, the acronym "TARP" had not been invented, "moral hazard" was just a concept and the phrase "too big to fail" was not used in common parlance. Anyone would have been hard-pressed to foretell events such as the failure of Lehman Brothers, the government rescue of AIG, or the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Even nature didn't cooperate during the period. Tsunamis of gargantuan proportions devastated Indonesia and Japan, earthquakes with magnitudes of 7.0, 8.8 and 8.9 hit Haiti, Chile and Japan, respectively. At the time of the writing of this report, there is political upheaval not seen in decades in North Africa and the Middle East.

All the turmoil shook consumer confidence in large financial institutions but retirement plan providers emerged largely unscathed—the industry was strengthened by a momentous change of attitude regarding the need to save for retirement. To many individuals, it has become clear that a retirement plan is not so much about investments as it is about personal lifestyle. Focus and attention have been drawn to retirement income security. A revolution in participant behavior is taking place that may enhance the retirement outlook of the workforce—all boding well for our industry. New investing opportunities appear on which participants are more likely to capitalize, thanks to lessons learned at the school of hard knocks.

Prescience 2013—A look back

That any of the predictions made in early 2008 became reality despite these uncertain times demonstrates the strength of the methodology of Diversified's *Prescience* study and the vision of the experts who contributed their insight. Anything could happen during the next two years, but many projections included in *Prescience 2013* are well on their way to becoming reality. Regarding investments for instance, 72% of experts had expressed the view that the Dow Jones would not reach 20,000 by the year 2013. At the time of the writing of this report, the Dow Jones was at approximately 12,000; any hope that it will

reach 20,000 is all but gone. On the fixed income side, stability was the consensus and the experts predicted that "bonds and alternative asset classes may end up the winners for the period." They emphasized fee disclosure as an area ripe for change. In fact, 73% of experts predicted that itemized disclosure of fees, commissions and revenue sharing on participant statements would be mandatory. Further 79% predicted that a standard format would be developed for this disclosure. The Department of Labor has now provided a model format for participant disclosures and is developing a model format for plan sponsor disclosures as well.

The *Prescience 2013* experts accurately predicted that healthcare reform would take center stage, the employer-based system would be maintained and the number of uninsured individuals would be addressed but the reform would not lead to universal healthcare. They also predicted that during the period, "pensions will take a back seat" and the "pressure on Social Security reform will be reduced in favor of more urgent priorities." The group projected retirement plan assets at $17.9 trillion in 2010 (according to ICI, retirement plan assets were $17.5 at the end of 2010). The group also projected assets of $25.1 trillion by 2013—a number that appears

hard to reach at this point, demonstrating that the time has come to recalibrate projections for the future. *Prescience 2015* helps us set new assumptions based on the current reality, and offers a solid set of predictions on which we can base our strategy for the next five years.

The retirement industry comes of age

The vision Diversified's *Prescience 2015* draws for the retirement plans business is that of an industry coming of age. Over the next five years, the industry will experience a period of relative calm. The economy will be growing slowly but steadily. U.S. equities will appreciate. Landmark legislation will be absent. This period of stability will allow the industry to take deliberate steps to enhance the retirement outlook of working Americans. Many steps put into action will come as a direct result of our recent experience through the Great Recession and lessons learned from behavioral finance research. On the one hand, the industry will be fully engaged in driving appropriate legislation and regulation—not by

conviction, but with confidence gained from real-life experience that the new regulations will change participant behavior for the betterment of society. On the other hand, segments of the industry will develop service standards by which plan sponsors will be able to gauge effectiveness in exercising fiduciary responsibility.

Growth and stability foster business development

We expect an environment of slow but steady economic development, political stability and predictable regulations. This environment will be favorable to the growth of retirement plan assets. The *Prescience* experts project that aggregate retirement plan assets will expand at an annual rate of 5.7% to reach $21.8 trillion by 2015. Defined contribution plan assets will grow faster—to approximately $7 trillion. The annual growth of the Gross Domestic Product (GDP) will consistently exceed 1.4%. Still, economic development will not be sufficient to quell the size of the federal budget deficit—the biggest issue with which our government will wrestle. The political stalemate between Democrats and Republicans in Washington will spare us from landmark legislation affecting the tax status of retirement plans. The focus of government action and of plan sponsors' Human Resources staffs will be the implementation of healthcare reforms. Although the 112th and 113th Congresses are not expected to pass much legislation, one new piece of legislation is anticipated to enhance safe harbors for Qualified Automatic Contribution Arrangements (QACAs) to allow default deferral rates in excess of 10%. This legislation will durably improve participant retirement outcomes and the industry's continued business success.

Professional retirement plan advisors maintain good order

Prescience experts project that by 2015, 35% of retirement plan sponsors will be using the services of professional retirement plan advisors. The business success of retirement plan advisors can be partially attributed to the strategic move to define professional standards for the industry in terms of fiduciary practice, contracting, revenue mix and fee disclosure. Plan sponsors working with professional advisors will maintain due diligence activity at current levels, but will reduce plan turnover and cost while placing pressure on service providers and investment managers to deliver quality consistent with stated policies and commitments. Increasingly, fee-based project consultants will be drawn to the retainer-model of professional advisors for business reasons and because of plan sponsor demands for ongoing service. Experts predict that by 2015, it will not be an option for advisors to receive compensation in any form other than fees, and that compensation will not be allowed unless the advisor assumes ERISA 3(21) fiduciary responsibility.

Successful participant outcomes attributed to plan design

The industry will recognize that participant behaviors are influenced by plan design. Automatic enrollment will be available in 72% of plans and automatically enrolled participants will make up nearly two-thirds of new participants in all 401(k) plans. The industry will focus efforts toward the regulatory approval of safe harbors for plan features that lead to successful participant retirement outcomes. The industry will also seek to leverage technology, particularly mobile technology, to nudge automatically enrolled participants into more beneficial saving and investing behaviors.

Technology drives participant communications

Service provider usage of social media will expand as it becomes a primary mode of communication for many consumers, particularly among newly eligible employees. Permission management for electronic communications will become more sophisticated, requiring the maintenance of preference information for multiple touch points, media and formats in which participants could receive messages. Personalization practices will take into account data aggregated from third parties not necessarily limited to financial institutions. The ability to reference the most recent interaction with a customer contact center representative in standard communications will allow better providers to stand out.

Participant access to advice at work will increase considerably. This is due partly to the Department of Labor's expanded exemption from prohibited transaction status for participant advice, and partly to the activity of professional retirement plan advisors who will play a role in the process. Intuitively, in-person advice is more effective at driving behaviors but economic realities may dictate other models—the jury is still out as far as which form of advice will predominate

Equity market growth and discipline smooth out the edges

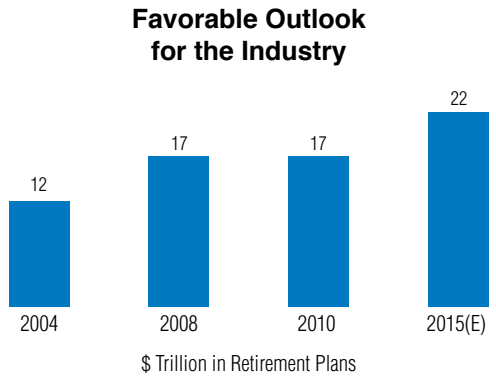
By 2015, a substantial 42% of retirement plan assets will be invested in Qualified Default Investment Alternatives (QDIAs), including target date funds, changing the way plan sponsors and participants look at investment options in retirement plans. The importance of asset allocation will be much more easily communicated in the new context. In the public psyche, 401(k) plans will be associated more with retirement income security and less with investing. However, stable value products will not obtain QDIA status. Target date funds will continue to be the subject of regulatory scrutiny, and plan sponsors that use the proprietary target date funds of their service provider will be subject to added layers of disclosure. Although volatility will remain high, U.S. equity markets will experience growth and the Dow Jones will once again reach 14,000. Bond market declines will not be as deep as some fear, but yield hikes will generate concerns for book-value products.

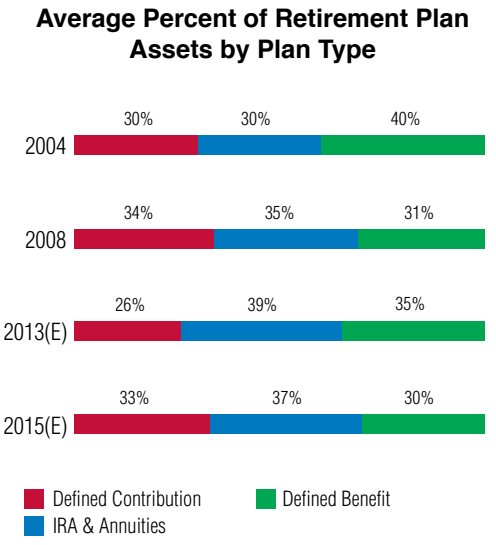
Some stable value product manufacturers will want to limit risk with liquidity features but there is only so much the market will tolerate. We expect that products with a 10-year market value adjustment will be under fire, changing long-held practices in the higher education and not-for-profit markets. At least one-quarter of private higher education institutions will have migrated to an open architecture, single-provider model.

Defined benefit plan terminations will increase and terminal funding business will nearly double, though it will still be restricted to insurance companies that have the unique capabilities and regulatory oversight to manage the process.

When we consider all of the trends that the *Prescience* panel of experts is predicting will occur through 2015, the vision for the retirement plans business is that of an industry entering into adulthood, confident enough to take the future into its own hands and to formalize business standards where none exist today. By 2015, retirement plans will be on a sound footing as regulations make it advantageous for plan sponsors to default participants into solutions that are more likely to lead to successful retirement outcomes, even in the absence of a defined benefit plan.

SURVEY FINDINGS





Economic and regulatory environment

Long-term growth for the retirement plans market is expected to resume between 2011 and 2015. Experts surveyed for Diversified's *Prescience 2015* project that retirement plan assets will grow at an annual rate of 5.7% to reach $21.8 trillion by the end of 2015. At that time, the defined contribution plans sector will represent one-third of retirement plan assets, as it did in 2008. The overall projected rate of growth is lower than historical levels but the defined contribution plans sector will grow faster than the rest. Equity market appreciation is one factor that will drive asset growth during the period, but other structural changes will also feed the trend.

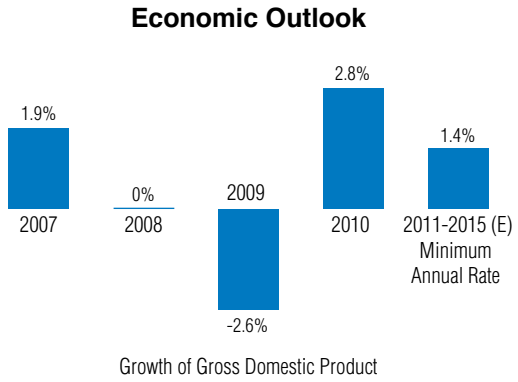
Consumer attitudes and participant behaviors have been altered by the Great Recession, driving contribution levels upward. Experts predict that the Department of Labor will adopt new Qualified Automatic Contribution Arrangement regulations that will lead plan sponsors to modify plan designs for more successful participant retirement outcomes—yielding even higher contribution rates. On the other hand, defined benefit plans will continue the pattern of long-term decline.

The rate of projected growth is lower than historical trends and past estimates. *Prescience 2015* panelists have become more conservative in this regard. It will be interesting to observe with hindsight if our projections are accurate predictions or lowball targets.

Stability is good for business, particularly when it comes to retirement income planning. From this standpoint, our experts predict economic conditions over the next five years will be far more pleasant than during the most recent period. Both in terms of economic growth and inflation, experts project that we will return to pre-2008 historical conditions. The economy will grow at an annual rate in excess of

1.4% and inflation is projected to max out at 4.2% between 2011 and 2015—a level not seen since 2007.

Even if it materializes, the GDP growth projected by our experts will not be nearly enough to put a dent in the federal budget deficit. In 2010, federal spending was nearly 24% of GDP and the federal budget deficit was at 9% of GDP, a level not seen since World War II. The federal budget is one key concern of the next five years that could potentially lead to reductions in Social Security benefits and greater involvement of our industry in the delivery of retirement benefits.

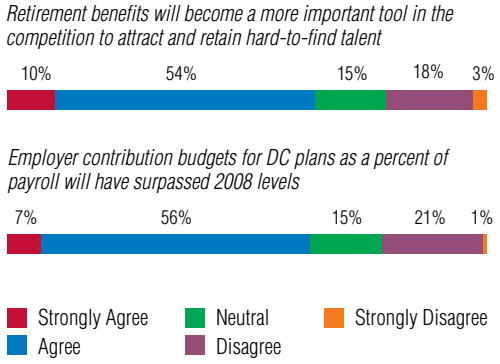


Five years of relative stability will lead to success for the retirement business. Plan sponsors gauge the value of the benefits they offer on their ability to help attract and retain talent. The budget they dedicate to their retirement plans is contingent on employee recognition of the value of these benefits. *Prescience* experts project good news on both fronts: 64% expect that retirement benefits will become more important in attracting and retaining hard-to-find talent and 63% anticipate that employer contribution budgets for defined contribution plans will surpass the 2008 level as a percent of payroll.

"We will have a meaningful recovery soon followed by a period of low growth and rising inflation as government monetary and fiscal policy trends back toward normal."

"The U.S. economy (and others) remain vulnerable to socio-political events, demographic shifts, terrorist attacks, competitive pressures on labor and capital and structural deficits that are likely to grow."

Retirement Benefits Will Become a More Important Competitive Tool



National Commission on Fiscal Responsibility

On December 1, 2010 the National Commission on Fiscal Responsibility and Reform appointed by President Obama issued its report, "The Moment of Truth," including recommendations to reduce the federal budget deficit to 2.3% of GDP by 2015. Many of the recommendations that are slated to be implemented by 2015 concern the retirement plans business. The overall objective of these recommendations is to encourage delayed retirement and to promote enhanced levels of retirement savings through the private system.

First and foremost, the Commission recommended that Congress pass legislation to delay the age for receiving early and full Social Security benefits by one month every other year for all future recipients. The Commission also recommended that Congress adopt legislation to gradually move Social Security benefits to a more progressive formula, slowing future benefit growth for higher income earners, and to apply employment taxes to earnings above current maximums. If the Commission gets its way, the age for Medicare eligibility will be raised to match the age for full Social Security benefits, limits to pre-tax retirement plan contributions will be consolidated and reduced to $20,000 or 20% of income, whichever is less, and eligibility for the Saver's Credit will be expanded.

The Commission's recommendations affect government plans as well. Modernization of the federal civil service and military retirement system will bring both systems more in line with standard practices in the private sector, and all newly hired state and local workers will be covered under Social Security. The Commission also recommended giving the Board of the Pension Benefit Guaranty Corporation (PBGC) authority to raise the premium rate. This would be expected to restore solvency and to cover shortfalls avoiding the need for government rescue in the future.

The vast majority of panelists believe that the reforms recommended by the Commission will fall short of reducing budget deficits to 3% of GDP. One reason volunteered is that the political stalemate between Republicans and Democrats in Congress is expected to continue beyond the 2012 elections. Experts are particularly skeptical about the likelihood of reforms to Social Security and the Federal Employee Retirement System. Panelists are projecting that the current tax status of retirement benefits and contributions will remain as is, and the current 402(g) limit-setting process will remain in place.

"Social Security will continue to be a political third-rail which most legislators will be reluctant to seriously curtail, though eligibility for early or full benefits may be subject to revision for younger workers."

A majority believe that the population eligible to receive the Saver's Credit will expand, even though regulators will shy away from any change that will increase short-term costs to the federal government.

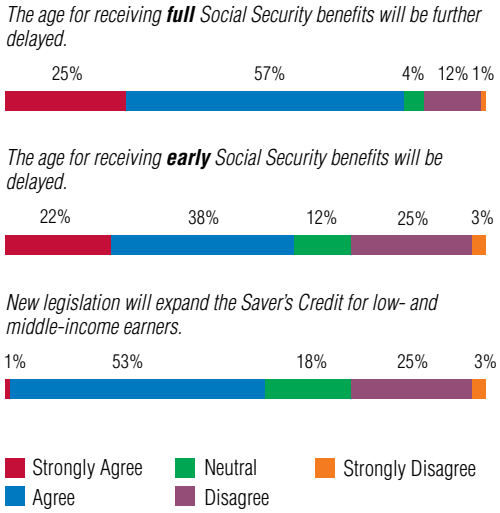
Looking beyond the recommendations of the Commission, experts are not projecting any foreseeable retirement plan regulatory changes. Legislation mandating that plans allow Roth contributions is unlikely. Also unlikely is the levying of a federal sales or value-added tax that would curb consumer spending and therefore encourage retirement savings.

Impact of healthcare reform

The retirement plans business may be spared any legislative changes, but healthcare will get plenty of attention between now and 2015. That is not necessarily good news for retirement plans.

Clearly, healthcare initiatives will devour Human Resources staff time until the healthcare reform process is fully implemented in 2014. Conversely, more than 80% of experts agree that Human Resources staff will be able to dedicate neither time nor resources to retirement plans functions. Although employers will be focused on healthcare, they will be reaping very little benefit from this effort, as the reform will not immediately instill a stronger sense of security among the U.S. population. The American workforce will still be concerned with achieving a successful retirement.

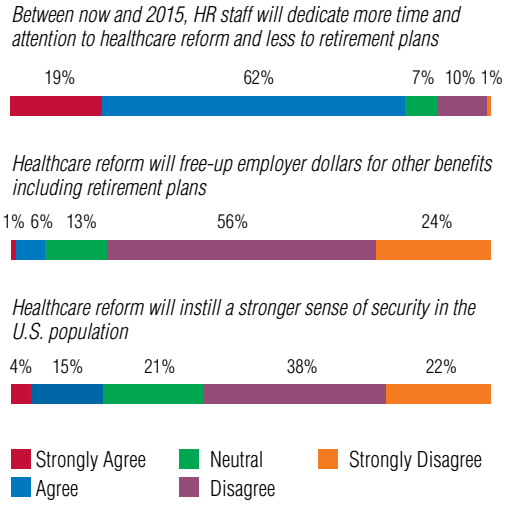
Greater Emphasis on Personal Responsibility



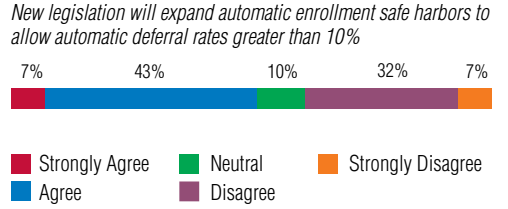
"The 2010 election results significantly reduced the possibility of any DC plan mandate. The current fiscal situation reduces the possibility of changes that will increase retirement savings. It will take everything we have to hold the current position. From 1993 to 1996, virtually every tax bill included provisions that reduced retirement savings."

"The primary focus of Congress will be on the deficit and healthcare, leaving little time or attention for retirement plan action. DOL and IRS will be the source of any new retirement plan regulation."

Healthcare Reform Takes Center Stage



Automatic Enrollment Safe Harbor



Potential legislation for automatic enrollment

Automatic enrollment is the one area where legislative changes are achievable. Current safe harbors for automatic enrollment allow for a contribution level of 3% in the first year, increasing 1% per year up to a maximum of 10%. For the vast majority of employees, this contribution level is insufficient to fund a successful retirement. With experience, our industry has learned that among those automatically enrolled, few participants make changes to the default elections even though these default elections do not place them on a path to success.

The laws must be changed to grant safe harbor status to plan sponsors who default participants at contribution levels sufficient to achieve retirement success. Conversely, one might question why plan sponsors who set default contribution levels too low to help the majority of their employees achieve a successful retirement should benefit from a safe harbor. Fifty percent of experts agree that Congress will pass new legislation expanding automatic enrollment safe harbors to allow default deferral rates above 10%. We have identified this issue as one ripe for concerted industry action to rectify a wrong and enhance the retirement outlook for more working Americans.

Emergence of professional retirement plan advisor

The facet of the retirement business expected to experience the most change is that of plan advice, service and distribution. At one point, retirement plans with $25 million to $1 billion in plan assets were fought over by broker-dealer representatives who also offered wealth management and fee-based project consultants with an investment or benefits practice. Many mid-market plan sponsors now find either solution to be a poor fit for their needs after the initial search process. The need for ongoing holistic service from a third-party is leading many plan sponsors to opt for a professional retirement plan advisor—an emerging group of professionals who service plans mostly on a retainer basis.

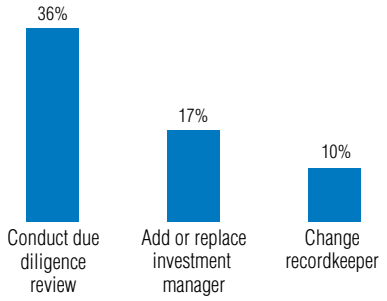
The development of this group, whose income depends less on vendor searches and more on the retirement success of participants, is leading to a fascinating change in plan sponsor behavior. By 2015, the level of due diligence activity is expected to remain high (a little more than one-third of plan sponsors will perform due diligence of their service provider in a given 12-month period) but the percentage of those who actually make a vendor change will be markedly down. In a given 12-month period, only 10% will actually change service providers and

17% will add or replace at least one investment option. This increase of due diligence searches and "price checks" will help keep costs reasonable for plan sponsors and participants alike.

The emergence and organization of professional retirement plan advisors will have a profound impact on the business over the next five years. These professionals are dedicated to the retirement plans business and retained by their clients to deliver holistic service with the ultimate objective of helping the greatest number of participants achieve a successful retirement. Among plan sponsors switching providers, nearly as many (35%) will use the services of a professional retirement plan advisor as will turn to an employee benefits or investment consultant (38%). This is a clear indicator of success for this channel.

Annual Provider Turnover Rates Remain at their Current Levels

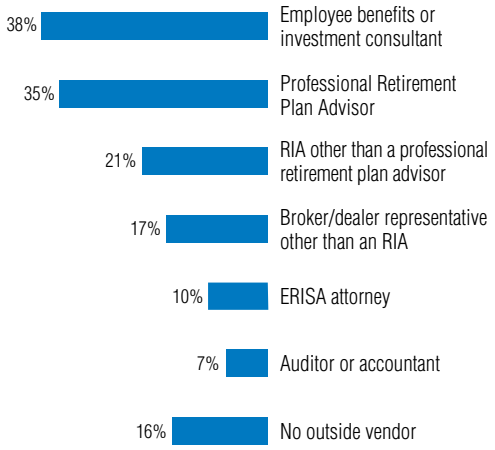
Percent of plan sponsors, who will



The success of this group of advisors will stem from key trends that experts agree will take place over the next five years. These advisors will have established professional service standards in multiple areas including fiduciary practice, contracting, revenue mix and fee disclosure. It is daunting for any group to establish standards of practice; it is even more so for a group that is emerging from very diverse backgrounds.

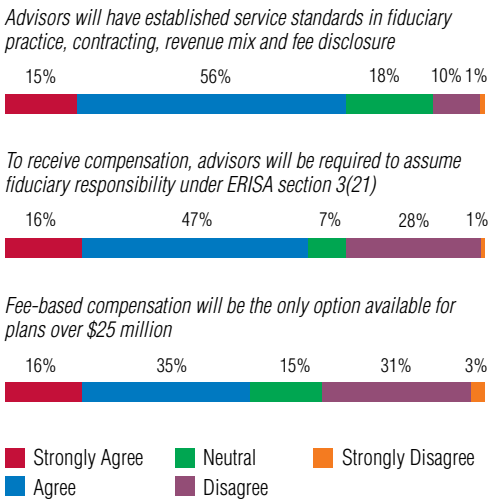
Going forward, fee disclosure will make it difficult for plan sponsors with retirement plan assets over $25 million to compensate an advisor in any way other than a direct fee for service. Plan sponsor demand for fee compression also bodes well for professional retirement plan advisors. Indeed, as more plan sponsors seek to reduce cost for the benefit of participants, many will look to shift from an asset-based advisor compensation model to a fee-based model while maintaining the same level of service. The leap of faith from a good advisor to an unknown project-based consultant may prove too daunting for many sponsors who may be able to convince their advisor to accept a predictable retainer.

Consultants and Professional Retirement Plan Advisors Retained by Sponsors when Switching Vendors



Another widely held view swelling the ranks of professional retirement plan advisors is that by 2015 advisors will no longer be in a position to receive compensation unless they assume ERISA Section 3(21) fiduciary responsibilities. This would be a departure from the current regulatory framework that allows plan sponsors to choose from three major models: the broker-dealer, the consultant and the advisor models. A requirement that advisors assume 3(21) fiduciary

Standards for Retirement Plan Advisors/Consultants Expected



responsibilities (limited or full scope) to receive compensation could lead the largest broker-dealer firms to segregate or spin off their advisory business into a self-contained subsidiary with an arms-length business relationship.

Broker-dealer representatives focused on wealth management play an important role in the distribution and service of retirement plans. Regardless of the strategy their firm adopts, these representatives will continue to be influential, but most will need to rely on support services from a professional retirement plan advisor with the depth of knowledge, skill set, tools and service model required to provide the service that sponsors of that size expect. Registered Investment Advisors focused on wealth management will also seek to work with professionals to support their retirement plan clients.

It is too early to tell what standards professional advisors will have established by 2015, but we expect that plan sponsors will follow the same standards in their exercise of advisor due diligence. Practitioners who cannot meet these standards will need to adapt into a different type of retirement plan professional, or plan an exit strategy for their business. We believe that the service standards of professional retirement plan advisors will be increasingly sought-after in the jumbo plans market as well, and that some fee-for-service consultants will look to the advisor business model as a way to augment service offering so as to further develop their practice with existing clients. Another group

"Retirement plan specialists will rapidly gain market share as distributors in the small business retirement plan market and effectively squeeze out non-specialists."

"The use of intermediaries will continue to grow. Also, the days of the casual offender retirement advisor are numbered. The job is too difficult and the potential liability of a fiduciary breach too great for non-specialists to continue to serve the market."

"Increasing number of plan sponsors and their legal counsel will value expertise and experience in provider searches."

of employee benefits and investment consultants may become heavily involved in the advisor search business for some of their clients with a stronger appetite for fiduciary support.

As plan sponsors increasingly rely on their professional advisor for decisions, the successful providers will be those who are best able to develop and maintain productive business relationships with advisors and consultants. Client retention and relationship development will figure even more prominently in the incentive compensation formulas of provider staff.

The trend toward reliance on professionals is seen at the participant level as well. There is considerable evidence that many American workers would prefer to rely on a knowledgeable expert to make their 401(k) investment decisions rather than learn about investments themselves. There is also some evidence that participants who use third-party advice at work enjoy higher investment returns in their 401(k) accounts. According to the Profit Sharing/401(k) Council of America's 53rd annual survey, 63% of 401(k) plan sponsors make investment advice available to their employees today and a mere 28% of participants with access take advantage of the service. Broader safe harbor protection for plan sponsors who offer advice would go a long way toward enhancing the retirement readiness of working Americans.

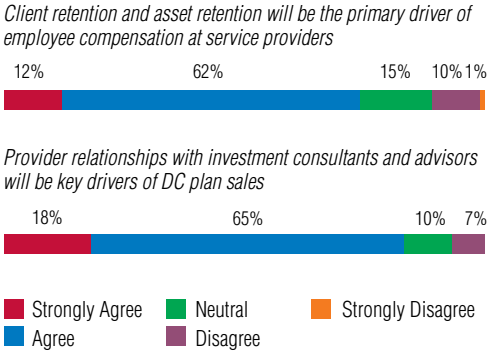
Participant strategy, investments and communications

The adoption of final Department of Labor rules exempting participant advice from prohibited transaction status under certain circumstances will contribute to the success of participant advice and the emergence of professional retirement plan advisors as a force in the industry. Still, only one-third of experts believe that legislators will take a logical next step to enhance retirement readiness by passing new legislation requiring that plan sponsors make some form of advice available to participants.

The jury is still out regarding the most popular form of advice service:

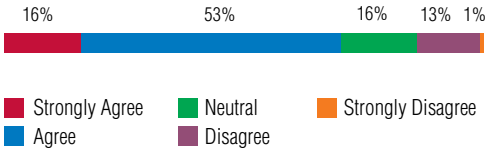
- Nearly two experts in five expect that a technology based solution from a party other than the service provider will be the leading Eligible Investment Advice Arrangement (EIAA)
- One-quarter of experts expect that more plan sponsors will opt for an in-person service from an independent third-party
- An equal number believe that a technology based solution from the provider will be the leading choice.

Relationship Development with Clients, Consultants and Professional Retirement Plan Advisors are Critical Success Factors

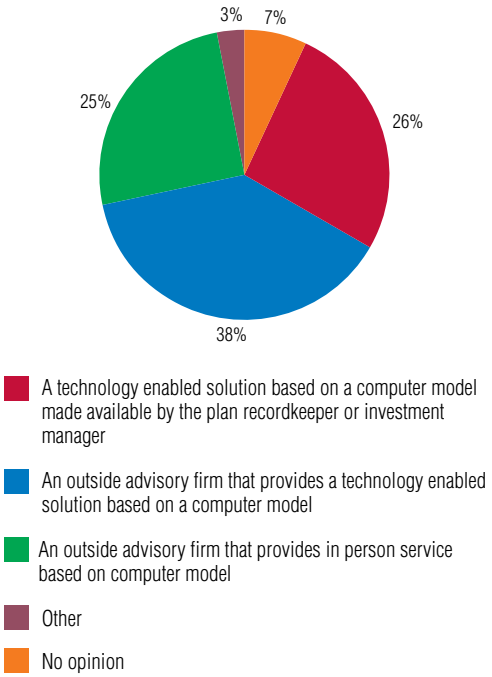


"The ability of product manufacturers and service providers to develop mutually beneficial relationships with key distribution partners in targeted markets will be the key to success."

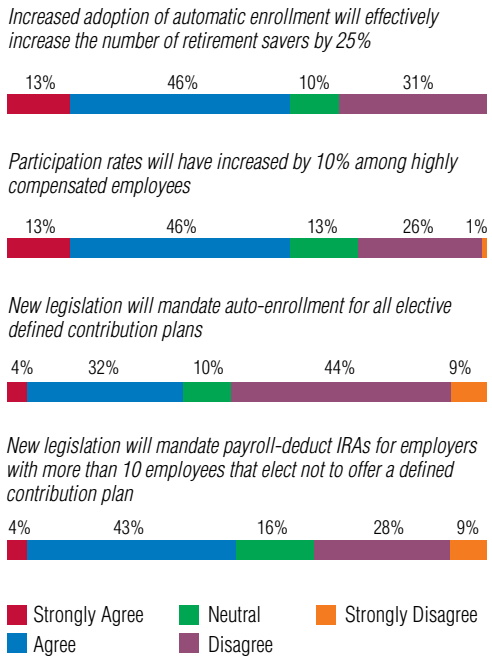
Participant Advice More Commonplace



Most Popular Eligible Investment Advice Arrangement (EIAA)



Automatic Enrollment Will Increase



Perhaps as a consequence of increased access to advice, Registered Investment Advisors and retirement plan service providers are most likely to experience business growth from the individual retirement markets over the next five years.

Come 2015, the retirement outlook of working Americans will be improved. The increased availability of advice at the workplace and the adoption of enhanced QACA safe harbors will drive progress. Experts predict that 72% of plans with $25 million to $1 billion in plan assets will have adopted automatic enrollment, up from 50% to 60% today. The majority of panelists agree that increased adoption of automatic enrollment will boost the number of retirement savers by 25% and the rate of participation among eligible non-highly compensated employees will jump by 10%.

Automatic enrollment and other automatic plan features are designed to capitalize on the inertia of many people who are faced with a daunting decision. Widespread adoption of automatic enrollment substantially increases participation among eligible employees, but it's a double-edged sword as it also instills inertia among participants who may have otherwise elected higher deferral rates. Experts project that by the end of 2015, almost two-thirds (65%) of new enrollees will adopt default elections without change, nearly all of them investing only in QDIAs. By then, a substantial 42% of all defined contribution plan assets will be invested in QDIAs and nearly 40% of participants will keep their assets with the retirement plan provider (in the plan or outside the plan) upon their retirement.

"For the most part participants will continue to seek advice from a human being—an informed professional whom they trust—but increasingly they will use digital tools to educate themselves about the financial risks they will face in retirement and how they can use an advisor and/or financial products effectively to achieve their goals."

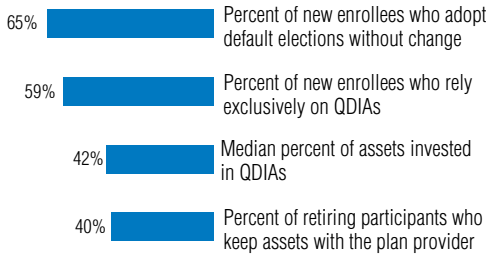
Investment managers with a defined contribution plan specialty have been quick to capitalize on this trend by developing a broad range of investment funds that fit the requirement of a QDIA. In the absence of a standard, sorting through fund families to identify the one that best fits a given plan is a challenge. Focusing on target date funds with the same investment horizon, the breadth of asset classes included varies widely among offerings and there is no consensus on target asset allocations. Investment policy statements range from very strict to downright permissive. Tools have appeared on the market to help plan sponsors sort through fund offerings, but more in-depth work will be needed going forward as managers seek to differentiate themselves with ever-finer strategy enhancements. To contain fiduciary exposure, discerning plan sponsors will scrutinize the default investment options available in their plan. They will monitor funds with increasing frequency for performance, expenses and adherence to the stated investment policy.

As providers finalize the transition of their participant strategy from an approach emphasizing employee education and communication to one grounded in behavioral finance principles, technology will become even more critical. To nudge automatically enrolled participants into action, providers will need to become extremely proficient with web analytics to drive the click-through pattern of users. The rise in popularity of mobile technology in particular will test provider innovation and flexibility.

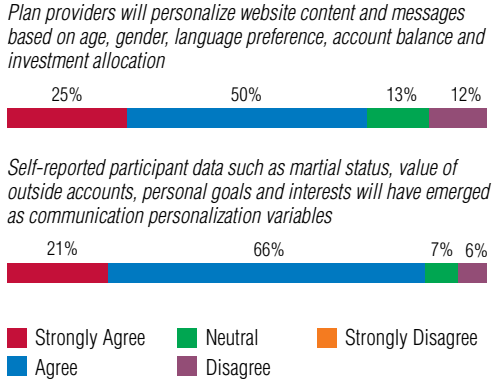
Legal and compliance departments will be challenged to establish new rules of engagement to address the need to leverage social networking, in order to communicate with participants who use social media as their primary communication tool. How to engage participants with concise and catchy messages leading them to act without falling into self-absorbed entertainment will be the challenge. Instant messaging will be a valuable tool to keep communication lively and purposeful.

Going forward, personalization will be achieved using self-reported variables not available on recordkeeping systems. This will include personal goals and interests, some of it aggregated from third parties (financial institutions and others). Although not all providers will offer live video access to contact center representatives, the capability will set the more advanced providers apart.

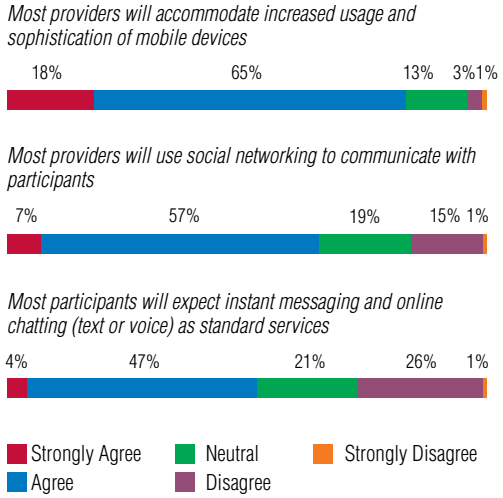
Automatic Features to Overcome Participant Inertia: A Double-Edged Sword?



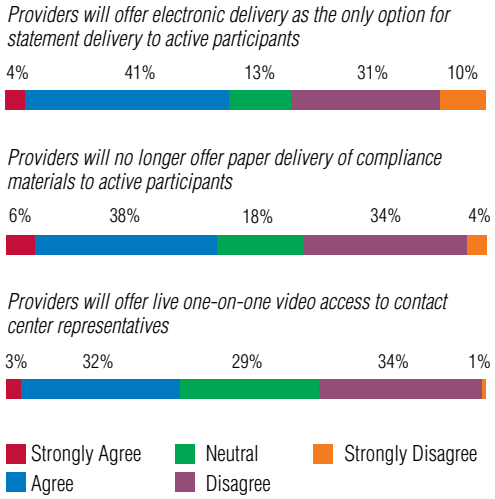
Website and Communication Personalization Based on Demographic Data Expected



Communication Technology Capabilities Drive Success



Electronic Delivery of Communications and One-On-One Experience



For all the talk about technology, paper is not dead yet! While some providers will offer electronic delivery as the only option for statements and compliance materials, experts are divided on the subject of whether that will be the norm. By 2015, firms will vary greatly in terms of e-communication preference management capabilities. While some will be limited to a single opt-in statement and compliance e-mail preference field, others will have developed entire menus so participants can personalize not only how they receive communication but also what communication they receive and in what media they prefer the message to be delivered. The most advanced providers will be able to further personalize messages to include a reference to the customer contact center representative with whom the participant had interaction most recently.

For most American workers, particularly those nearing retirement, changes occurring with automatic plan features and default investment election scrutiny are coming too late to have more than an incremental impact on retirement outcomes. Still, improvements are in the air.

"Tick, tock the impact of

aging demographics coupled with the underfunding [of] Social Security and Medicare will be like watching a car crash in slow motion. Not pretty."

"As more baby boomers retire, more emphasis will be placed on how to manage your money during the spend-down phase. More emphasis will also be placed on helping current participants translate their account values into a relatable number for a monthly retirement income."

"I believe a significant minority of baby boomers will be looking to their children for help, rather than being able to help their children."

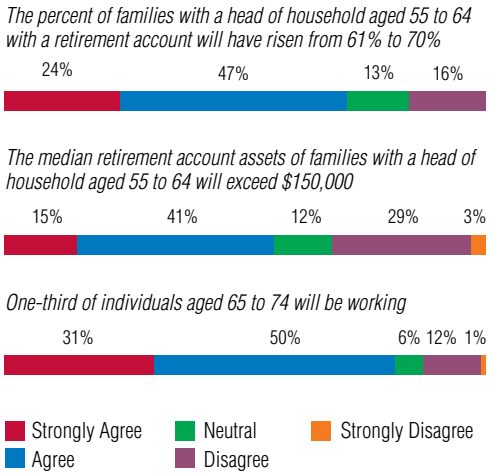
Experts foresee that 70% of families with a head-of-household aged 55 to 64 will have a retirement plan account, up from 61% today. Further, the median value of that account will exceed $150,000, up from $100,000.

Changes in attitudes and enhanced returns in U.S. equity markets will play an important part in these notable improvements, but for the majority of workers, these amounts will not be anywhere near enough to fund a sufficient retirement income. We project that more than one-third of individuals ages 65 to 74 will be working and a majority of these workers will be saving a portion of their earnings for "true old-age."

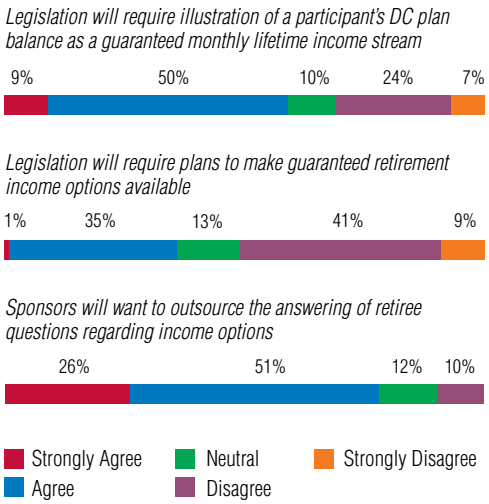
Since most plan sponsors offer only a defined contribution plan, and participant account balances do not easily translate into a retirement income figure, many plan sponsors will be concerned with ways to transition participants to a retirement income mindset. By 2015, legislation is expected that will mandate illustration of account balances in terms of a guaranteed lifetime income stream. However, many sponsors will provide this number for illustrative purposes only because legislators are not expected to require that plans make income guarantees available to participants. Obstacles to annuitization and income guarantees will remain.

As greater numbers of baby boomers reach retirement age, net distributions from retirement plans will play a more prominent role in the economy. Regulators and economists will pay close attention to the flow of distributions. Facing increased pressure to apply the same fiduciary zeal to the distribution process that they deploy for the selection and monitoring of investment options, large numbers of plan sponsors will choose to outsource retirement counseling to advisors and service providers. This is yet another reason why saving and investing advice will continue to be a leading industry trend over the next five years.

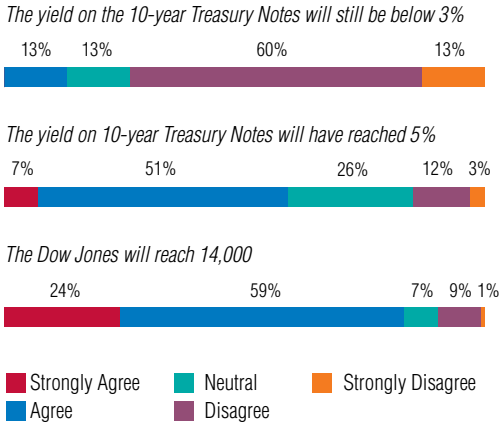
Readiness Improves but a Growing Number of Early Retirees Need to Work to Supplement Income



Transitioning Participants to a Retirement Income Mindset is a Recurring Theme



Bond Markets Poised for Major Changes and Experts are Bullish about Stocks



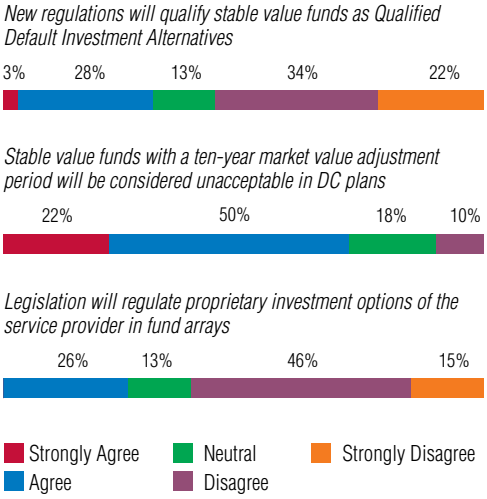
Investment trends

We are entering a phase of declining bond market values. Experts are not predicting a major increase in bond yields by 2015. The majority predict that the yield on 10-year U.S. Treasuries will rise to 5%, but the near-unanimous consensus is that the yield will not rise to 10%.

Undoubtedly, plan sponsors will seek strategies to protect their participants from the brunt of a down market. This cycle presents an interesting dilemma for firms that specialize in managing book value products such as general account products and stable value funds. These products will be in high demand during the period as the guarantees they provide become even more attractive. The temptation might be for these firms to tweak liquidity features, in particular to lengthen the market value adjustment period. There are limits to what the market will bear, however. Current practices of some providers may come into question. Seventy-two percent of experts agree that stable value products with a 10-year market value adjustment will be considered unacceptable by 2015.

Given these constraints, the momentum of bond funds that employ hedging strategies or that invest in inflation-protected bonds will continue well into the future.

Stable Value Products with a 10-year MVA Period Under Fire



"Market returns will be up and down and interest rates will remain low."

"Markets will see increased volatility as geo-political instability rises."

U.S. equity markets, where the bulk of defined contribution plan assets are invested, are poised for a serious rebound. Eighty-three percent of experts predict that the Dow Jones will have reached the 14,000 mark by the end of 2015, surpassing the peak of October 2007. U.S. equity markets will be the engine of growth and profitability over the next five years and as a result, the U.S. equity markets will remain the largest in the world. Few experts predict that the Shanghai equity market will experience explosive growth again over the next five years.

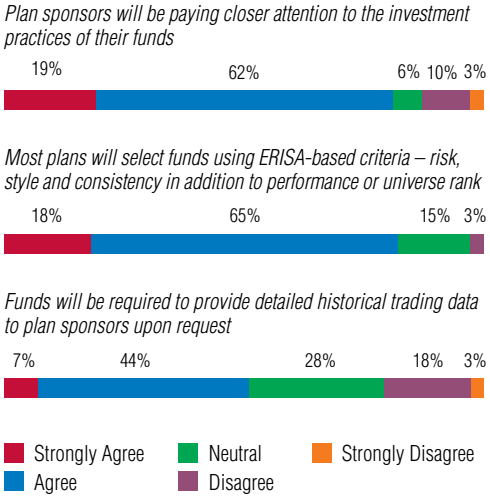
However, performance will come with increased volatility. While experts disagree on the amount of volatility that U.S. equity markets will experience over the period, risk remains the wild card when it comes to the short-term success of the retirement plans business. Providers' ability to live with risk will be tested during the period.

In spite of the higher U.S. equity market performance, plan sponsor vigilance with the selection of investment options in fund arrays will be sustained. Most investment policy statements will go beyond performance and universe rankings to embrace ERISA-based criteria such as risk and consistency. To meet the needs, we expect that investment management firms will continue developing defined contribution plan-specific practices. Our panelists project that 26% of retirement plan assets will be invested in institutional mutual funds specifically designed for use in retirement plans.

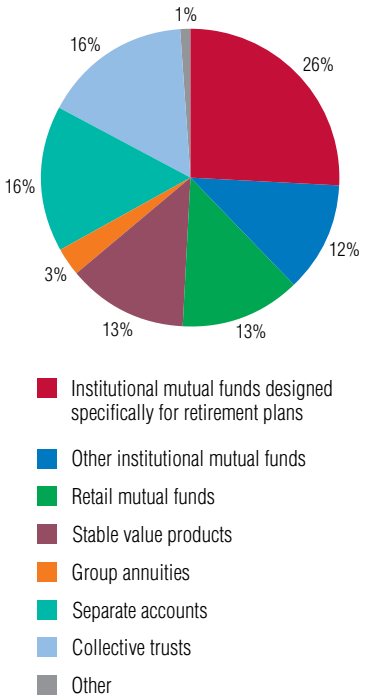
Plan sponsors will apply pressure on managers to disclose historical trading data beyond what is available from mutual funds today. If the mutual fund industry does not find a way to provide this information, some plan sponsors will look at alternatives not subject to the restrictions that apply to mutual funds. Collective trusts and separate accounts are each projected to hold 16% of retirement plan assets by 2015.

Target date funds in particular will be under scrutiny by lawmakers. Additional reporting requirements for plans that use the proprietary target date funds of their service provider as a QDIA are likely to lead some plan sponsors to separate the due-diligence process for service provider selection and target date fund selection. Providers unable to offer complete flexibility of target date funds may need to plan an exit strategy lest they face a profitability conundrum in a business

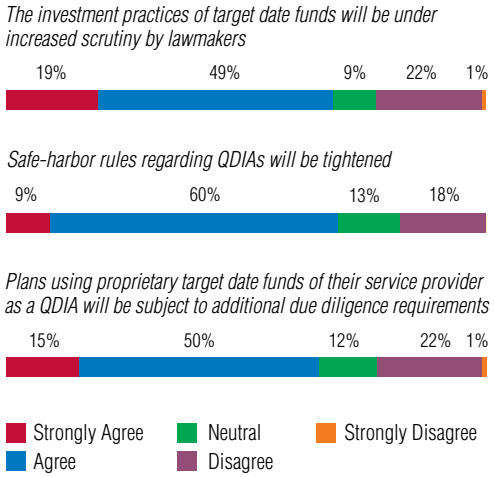
Plan Sponsors Become Even More Vigilant with Investment Selection and Monitoring



Percent of Defined Contribution Plan Assets



Lawmakers Focus Attention on QDIAs and Target Date Funds



already known for tight margins. We do not expect regulations that apply to Employee Stock Ownership Programs to tighten, nor do we expect legislation barring the use of company stock in retirement plans.

Answers to open-end questions suggest that product development activity will gain momentum. A number of firms will seek to develop absolute-return funds, to imbed guarantees or alternative asset classes in an attempt to expand diversification and reduce volatility. Although we do not have a measure of the likelihood of market success of these innovations, comments suggest that adoption will be limited.

"Annuities or guaranteed funds continue to struggle to gain

market penetration as participants are leery of anything 'guaranteed'. Absolute return funds will be more prevalent as participants understand this concept better and our European counterparts have seen the benefits of these funds."

"Hedge funds, commodity funds, managed futures funds will only be in target date funds and only a small percentage of those."

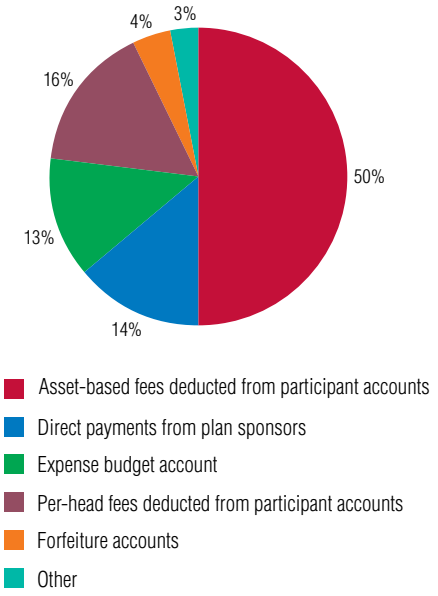
"Unfortunately new products will make an already confusing picture for participants worse. Many firms are adding derivatives to target date investments to differentiate their products and improve returns, though those same products are typically not fully understood and could have an opposite effect on the returns of the investment."

"Margins shrink for all players: recordkeepers, investment managers and consultants."

"The biggest issue will be with the recordkeepers who cannot offer open architecture; they are going to go the way of the dodo."

"While I expect fees to go up, I suspect margins—outside of those supported by investment management fees—to be squeezed by a new wave of reporting and regulatory compliance issues."

Defined Contribution Fees by Source



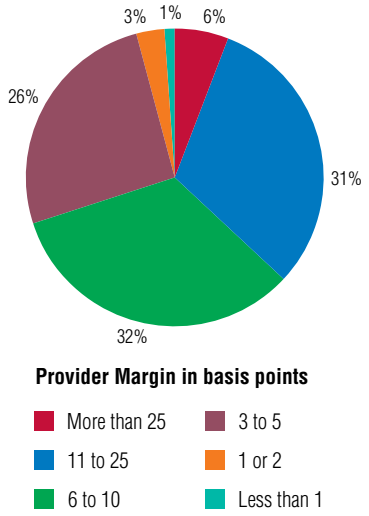
Industry structure

Experts surveyed for our last study suggested that, buoyed by equity market growth, service providers' profit margins would improve. Not so this time around: 62% of experts predict that by 2015, service provider margins will fall below 11 basis points. Pressures on pricing practices will squeeze profitability. Increasingly, plan sponsors will demand per-capita pricing and request guarantees, often for three-year periods. Plan participants will typically bear one-half the cost in the form of asset-based fees from investment management, with the balance coming from a variety of sources.

To manage the disconnect between asset-based revenue from investment managers and the capped cost of services, most plan sponsors will establish expense budget accounts. Service provider proficiency at managing these accounts will be an important factor in competition as more plan sponsors seek to levelize revenue across funds to avoid differentials between participants in the ratio of contribution to plan expenses. Retirement plan providers without a proprietary recordkeeping system will be only as good as their systems provider for these capabilities.

Service providers will no longer be the only targets of fee compression: advisors will be affected as more business shifts from an asset-based compensation model to a retainer model. Investment management firms also face the issue when participants become more aware that the bulk of fees go toward fund management.

Service Provider Margins Expected to Decline, Scale is Critical to Business Success



Mergers and acquisitions in the benefits consulting and investment consulting arena have been most visible in recent months (Aon and Hewitt, Callan and Mercer, Bostonian Group and Marsh-McLennan to name a few). Consolidation is expected to continue to affect consulting firms, service providers and investment management firms alike.

The need to meet corporate revenue targets and demands for complete open investment architecture will lead at least two major firms to spin off their retirement plan service business. Most vulnerable are the firms that rely on proprietary investment options for revenue, regardless of asset class, and those with a less-than-stellar record of managing relationships with professional retirement plan advisors.

"M&A activity will intensify as the economy recovers and those providers who have emerged stronger will inevitably overtake those who have become weaker. Providers will place even greater emphasis on rollover accounts and products to satisfy participants' retirement income needs."

"Recordkeepers, asset managers and distributors will need to re-examine their relationship to one another and develop new ways to compete for assets in a way that is beneficial to each partner in the food chain and to the end consumer."

> "Employers will continue to spend about the same amount on retirement benefits over the next five years. What will change is how employers use those dollars to impact participant behavior—for example by making participants have to defer more in order to capture the entire match."

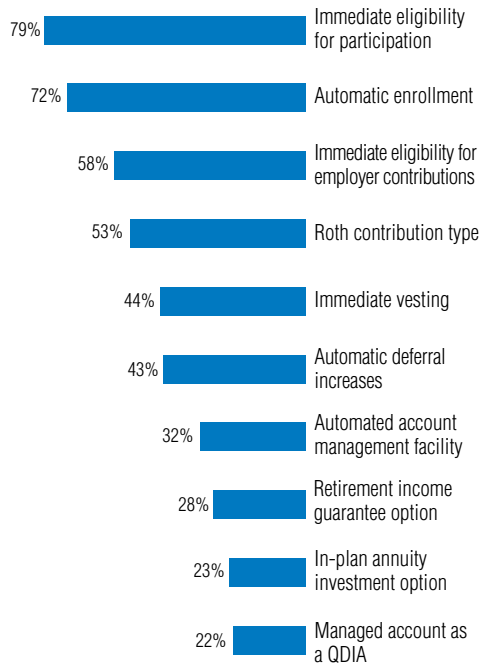
Plan design

The defined contribution plans of 2015 will be better-suited to help participants achieve a successful retirement. Automatic enrollment, now available in 50% to 60% of large plans, will be ubiquitous in 2015: experts predict that it will be available in nearly three-in-four plans. Automatic escalation, available in one-quarter of plans today, will be available in 43% of plans. Unless the standard automatic deferral rate is increased dramatically—to 12% or higher—we believe that pairing automatic enrollment with automatic escalation is critical to participants' achieving a funded retirement.

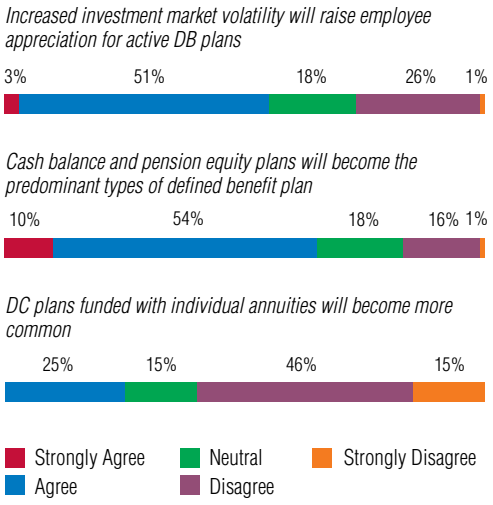
Not only will automatic enrollment be more common but QACA safe harbors will be better-aligned with the contribution levels required to reach sufficient levels of income replacement in the absence of a defined benefit plan. Twenty-two percent of plans will offer a managed account as a QDIA, and slightly more than one-quarter of plans will offer retirement income guarantees of some sort.

As automatic features become predominant, regulatory mandates and safe harbors governing default elections will become increasingly important in plan design decisions. We can infer that by 2015, a best practice might be a 401(k) plan with immediate eligibility for participation and employer contributions, matching $0.25 on the dollar up to 10% of compensation, automatically enrolling participants at 10% of compensation with 2% automatic annual escalation to a maximum of 20%. The fund array might include 15 funds allowing for broad diversification across asset classes. QDIAs might consist of managed portfolios of the underlying funds. A guaranteed monthly withdrawal benefit to match the QDIA with the asset allocation model with the shortest investment horizon would help more closely associate the plan with retirement income security and less with investments.

Adoption of Plan Features



There will be Growing Appreciation for Active Defined Benefit and Cash Balance Plans, but DC Look-alikes Not Expected to Gain Traction



Future of defined benefit plans

By 2015, 40% of employers with 5,000 employees or more will offer a defined benefit plan—active or frozen. Among the surviving plans, cash balance and pension equity plan types will prevail. Appreciation for defined benefit plans will improve greatly as their number dwindles. Thirty-six percent of plans in existence today will be frozen by 2015, and an additional 14% will be terminated.

More than one-third of plan sponsors will outsource all retirement plan functions to a single vendor. Total retirement outsourcing and defined benefit plan administration outsourcing will remain most popular among employers with frozen defined benefit plans.

The decline of defined benefit plans will accelerate with the rise in bond yields. The market for terminal funding will almost double by 2015, but it will not open up to investment firms that do not meet the strict requirements that apply to insurance companies. The rise in defined benefit plan terminations will have a direct impact on actuarial consulting firms and defined benefit plan administrators. As they conduct due diligence on termination solutions, plan sponsors will select providers with strong communication and service capabilities to facilitate the transition process with the least disruption possible.

"The current DB system will continue to decline until only companies in special cases have DB plans (i.e., small professional firms, utilities). Then, more modest DB plans will be introduced at some companies to supplement the DC plan, which will be the main retirement program."

"More than half of private defined benefit plans will go through standard termination (i.e., fully-funded termination and annuitization) as soon as interest rates go up enough to make the plans appear well-funded."

"Technology has made data sharing easier and as a result, plan sponsors will migrate to 'best in class' providers for plan type. An exception may be frozen DB plans, where benefits have already been calculated. In that instance, DB administration is more likely to be bundled with DC administration."

"Companies will slowly consolidate retirement offerings as circumstances cause them to review their plans and providers, but it will be a slow and episodic trend."

The search for defined benefit plan substitutes will continue through 2015. Although we expect that regulators will mandate illustration of guaranteed income streams on defined contribution statements, the availability of annuitization options—let alone their use—will not be mandated. Defined benefit plan look-alikes funded with individual annuities will still be rare.

Executive compensation

Executive compensation has been in the line of fire for a few years now, even before the failure of Lehman Brothers and the rescue of AIG. Already, the addition of Section 409A to the Internal Revenue Code had placed a damper on nonqualified deferred compensation, and public outrage over the amount of compensation paid to executives of failing firms compounded the problem. There is little sympathy for the fact that a job as risky as that of chief executive of a failing firm commands superior compensation.

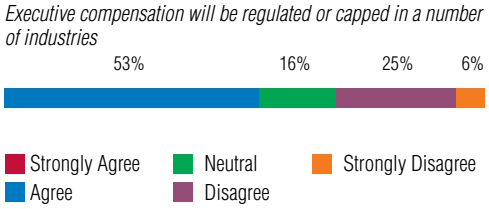
For this reason, lawmakers have taken steps to limit executive compensation in sectors that have been the target of major legislation such as healthcare, financial services and automotive manufacturing. Experts anticipate that these limits will expand going forward because executive compensation does not appear to have a positive effect on business or economic growth. The evolution of nonqualified deferred compensation plans will suffer from persistent image problems and government fiscal problems. Largesse is out.

Not-for-profit and Taft-Hartley

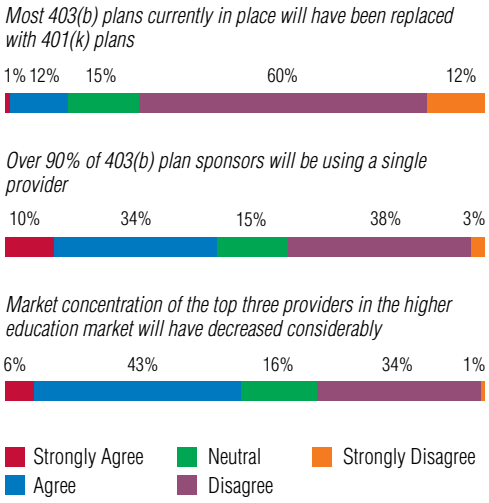
Historically, trends affecting 403(b) plans have been unique to that market. Reasons for the not-for-profit exception are historical and structural—and are expected to continue. Although regulations have been streamlined to make 403(b) plans more consistent with 401(k) plans, not-for-profit organizations intend to maintain their current plans. Most 403(b) plans in place today will still be in place in 2015, particularly in the healthcare sector which will scramble to keep up with the changes brought about by the reform process.

Vendor consolidation will continue, but a small and vocal minority of sponsors will persist in using multiple vendors. The market share of the top three providers in the higher education sector will erode as more institutions seek to take advantage of open investment architecture. Experts predict that one-quarter of private higher education institutions will be using a single open architecture vendor by 2015

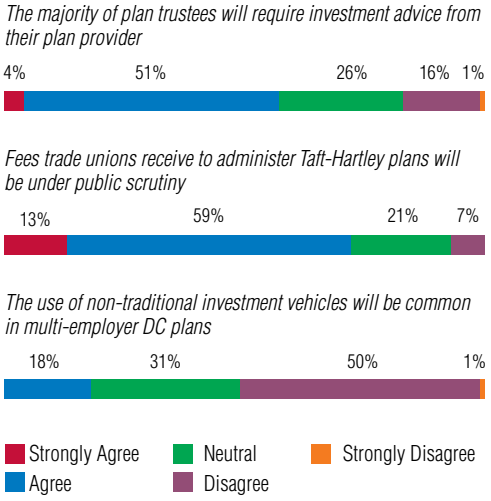
Executive Compensation will be Regulated



Current Trends Affecting the 403(b) Market will Continue but Changes will be Modest



Facing Increased Scrutiny Over Fees and Investment Selection, Trustees of Taft-Hartley Plans will Rely on Defined Contribution Plan Providers



and most retirement plan assets of the sector will be invested in mutual funds. In the public higher education sector, there still will be no end in sight to the short-funding of defined benefit plans. Employee cynicism at these institutions will grow, and reliance on 401(a) money purchase plans and 403(b) plans will become ever greater.

The pace of change in the multi-employer segment will accelerate. Outside the government and the service sector, the sharp decline of union membership will continue. More than one-half of all Taft-Hartley plans will be structured to allow elective participant deferrals and participant-directed investments. Trustees will be more conscientious when it comes to the selection and monitoring of investment options. Plan-level advice will be a prerequisite for providers serving the market and there will be no room for non-traditional investment products. The TPA fees that trade unions receive to administer the plan will face scrutiny by the popular press, the general public and legislators.

CONCLUSION

Out of the Great Recession, the retirement industry is poised for a period of growth. Change is in the air. Experts surveyed for Diversified's *Prescience 2015* depict the retirement plans business coming of age within the next five years. Strengthened by knowledge gained from recent experience and buoyed by the confidence that the principles of behavioral finance will help enhance the retirement outlook of many participants, the industry stands ready to close the door on defined benefit plans—and to implement the bold defined contribution plan designs that can lead participants to successful retirement outcomes by default.

Our panel of experts—the largest ever assembled for a *Prescience* study—anticipates a welcome period of steady economic growth, solid equity market growth and regulatory stability. The industry is ripe for the kind of proactive initiative that breeds positive change.

Change will affect every sector of the industry for the benefit of plan sponsors and participants. Professional retirement plan advisors will establish professional standards, investment management firms develop Qualified Default Investment Alternatives that satisfy enhanced scrutiny by plan sponsors, regulators and service providers will leverage new media to engage automatically enrolled participants to act responsibly. Consolidation will weed out the least efficient firms who are unable to adapt to the new market conditions.

Although margins will be squeezed for all stakeholders as a result of disclosures, growth in the U.S. equity market will help maintain profits at a reasonable level. Firms' ability to manage expense reimbursement accounts will become critical to reconciling asset-based revenue streams with capped billing requirements. Only those firms with strong systems will survive. Stable value funds with market-value adjustment periods longer than 10 years "go the way of the dodo."

Defined benefit plan terminations will nearly double, boosting demand for terminal funding and associated communication and service capabilities. In the public sector, however, reforms needed to fully fund defined benefit plans fail to pass. On the other hand, the PBGC will obtain the authority to raise premiums as needed to avoid systemic failure.

Segments that sometimes lag behind 401(k) plans—such as higher education, not-for-profit healthcare and Taft-Hartley plans—catch up with the rest. Private higher education institutions will adopt open investment architecture, Taft-Hartley plans will mature to implement elective deferrals and TPA fees that unions receive to administer the plan will be scrutinized.

Is the future of retirement plans all rosy? Investment market volatility is still a factor and only so much can be done to help older generations of U.S. workers who are woefully under-prepared for their retirement years. Still, the *Prescience 2015* panel of experts points to the progress that can be accomplished over the next five years as the industry works together to enhance the many facets of the U.S. retirement plans system.

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