Defined Contribution Plans: A Look at Contemporary Investment Best Practices

Constructing and communicating your investment lineup to increase positive investing behaviors.

By Kweku Obed with Introduction by Tony Verheyen

According to latest estimates by the Department of Labor and Employee Benefit Security Administration (See "Private Pension Plan Bulletin: Abstract of 2012 Form 5500 Annual Reports 2012" published in January, 2015), nearly 91 million Americans participated in 633,000 defined contribution plans representing nearly $4.2 trillion in combined savings. Clearly, the majority of Americans are relying on the Defined Contribution Retirement Plan platform to prepare for retirement.

As witnessed in the Supreme Court's recent Tibble ruling and the Department of Labor's proposed change to the Fiduciary Rule, unforeseen shifts in the system's foundation have the ability to alter the landscape as we know it. These shifts remind us of the ongoing evolution of the Defined Contribution Retirement Plan and corresponding investment landscape.

In the following article, Kweku Obed, a contributing member of PSCA's Investment Committee, offers an intriguing examination of contemporary best practices in a relevant, historical context.

Best Practices: A Tiered Investment Lineup — Past and Present

Given the varying degrees of sophistication among participants and our tendencies as human beings to make irrational decisions when faced with multiple choices, simply offering funds across the investment spectrum without much guidance can induce unhelpful behaviors such as procrastination and inertia. Consequently, the tiered investment structure was developed as a means of positively tackling some of the common behavioral biases (summarized in Exhibit 1) that can impede a participant's efforts to build and adequately manage an investment portfolio.

A typical tier structure will have three pillars, namely:

- **Tier I:** A "one-stop shop" fund solution, typically a TDF (target date fund) or lifecycle fund
  - **Objective —** to provide a "set and forget" fund option for reluctant investors
- **Tier II:** A "core" set of actively and passively managed funds
  - **Objective —** to provide a diversified set of "core" building blocks for more hands-on "Do-It-Yourself" (DIY) investors
- **Tier III:** Where applicable, specialty options or features (for example a mutual fund window or a specialty standalone fund)
  - **Objective —** to provide additional options for DIY investors that are the most hands-on

Presenting a DC plan's investment options via the tiered structure is a practical way to show a participant how certain investment options may be appropriate for him or her (Exhibit 2). For example, an employee that is fee

Exhibit 1: Common Behavioral Biases that Can Affect Investment Behavior

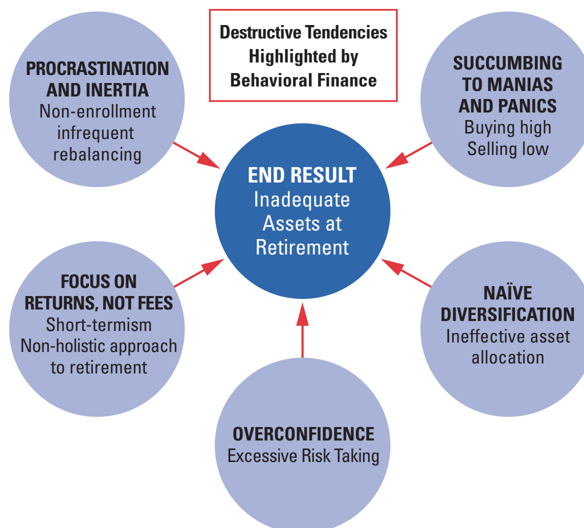
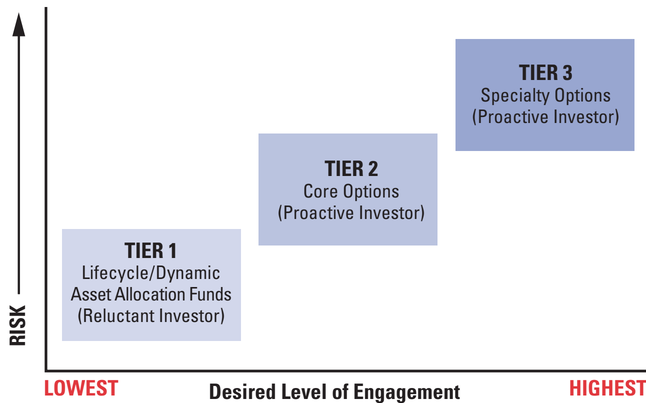


Exhibit 2: Tiered Structure for Investment Lineups



conscious and does not spend too much time pouring through prospectuses and quarterly statements would be a good fit for a TDF (tier I) allocation versus maintaining self-managed exposure to tiers II or III. However, it should be noted that while the tiered framework is becoming the most common approach to present a DC plan's investment lineup to participants, not all plans have officially adopted the tiered approach. We recommend that this newer wave of "pending tier structure converts" work closely with their recordkeepers and if applicable, consultants, to devise targeted communications for participants. These materials should clearly define the tier structures and highlight the profiles of the typical investors that would choose a tier I, tier II, or tier III option. Based on our own experiences, targeted communication campaigns can provide participants a better understanding of the different tiers and significantly reduce the inappropriate use of fund options both across and within the separate tiers.

Best Practices: The Tiered Investment Lineup — The Future (White Labeling and Going Global)

A solid DC investment lineup should provide participants clear exposure to capital preservation, income, capital growth, and inflation protection (either on a standalone basis via tiers II and III, or as part of a bundled one stop tier I solution such as a target date fund). If we couple this view with the mainstream acceptance of behavioral finance and one of its key conclusions — streamlined choices presented in an easy to understand framework should lead to better investment decisions made by participants — we expect to see increased demand from the plan sponsor community for the adoption of "white labeled" funds and the increased use of "global funds" in investment lineups (Exhibit 3).

White Labeled Funds

Behavioral research has shown that the typical investor may have a tendency to attach positive or negative historical connotations to his or her investment decision making. This phenomenon is known as "anchoring" and can manifest itself through destructive behaviors such as chasing returns. In addition to return-chasing behavior, anchoring can lead investors to select or ignore funds based on brand name recognition rather than more important factors such as the suitability of the asset class relative to long-term objectives.

Consequently, white labeled (generic named) funds can add further simplification to the decision-making process because they do not list the names of underlying fund managers, thus removing any conscious or subconscious biases that an investor may have about a particular asset management team or firm. Also, by white labeling a fund (for example "Target Date 2050" or "Global Fixed Income"), the individual is in a stronger position to select an option based on whether that strategy or asset class is an appropriate fit for his or her long term objectives and constraints.

From the plan sponsor's perspective, the ability to offer a generic labeled fund should allow for a more straightforward participant communication strategy, as the focus of the literature will be on the fund and asset class (versus the asset manager or any "star" portfolio managers). Additionally, we have found that from time to time, there may be reluctance from the plan sponsor's end to remove a well-known brand name from their plan's lineup as they are worried that participants may be upset or disincentivized by the change. With white labeling, it may be easier for a plan sponsor to switch out a fund that has failed to meet its objectives when it is not associated with a brand name.

"Globalizing" the Fund Line Up

Given the variety of reasons listed in previous paragraphs, some key goals of the typical DC fiduciary should focus on simplifying the participant decision-making process and eliminating any redundant overlaps between the investment options offered to individual investors. Additionally, a sound DC

Exhibit 3: White Labeling of Investment Funds

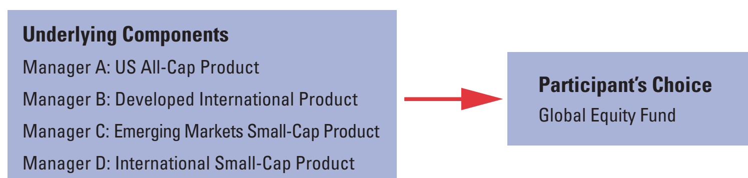


Exhibit 4: "Globalizing" Your Investment Lineup

Capital Growth	Domestic All-Cap Equities Developed International Emerging Markets	▶ Global Equity
Capital Growth	Domestic Equities Developed International Emerging Markets	▶ Global Large-Cap Equity
Capital Growth	Small-Cap Domestic Small-Cap Developed Emerging Markets	▶ Global Small-Cap Equity
Income	Global Core Senior Secured Loans Low Volatility Unconstrained	▶ Fixed Income
Capital Preservation	Stable Value / Money Market Low Volatility Fixed Income	▶ Capital Preservation
Income Protection & Diversification	Real Estate / REITS Inflation Protection Services Open End Infrastructure	▶ Capital Growth

lineup should offer participants access to capital preservation, income, capital growth, and inflation protection via tiers II and III or as part of a tier I TDF.

One of the most straightforward methods to achieve these objectives through tiers II and III is to employ broader mandates such as global fixed income, global equity, and global inflation protection funds. Broadly speaking, these global mandates can either be off-the-shelf, i.e., offered by a single asset manager, or custom built, i.e., a collection of different underlying funds that are managed and rebalanced to specific asset allocation targets (Exhibit 4).

In our experience, some plan sponsors have initially been reluctant to substitute their dedicated offerings to U.S. large cap, U.S. mid cap, U.S. small cap, and International equities with one global equity fund. One reason behind this reluctance includes the perception of increased manager concentration risk; some may read this example as an act of taking away four strategies that may be managed by different entities in favor of one global strategy that is offered by a single manager.

Additionally, if many of the standalone options in a DC plan have seen strong performance, there may be some further reluctance to change to a global framework out of fear that removing well-performing funds will discourage employee participation. In the face of these valid concerns, it is important to note that moving to a global and streamlined lineup does not automatically mean that a plan sponsor has to replace all his or her existing managers or assume undue levels of manager-concentration risk.

The argument for considering a global fund framework is also compelling if we shift our focus to the role of fixed income in a DC plan relative to the recent conclusion of the Federal Reserve's (Fed) Quantitative Easing (QE) program and the increased possibility of interest rates rising in the coming years. Broadly speaking, the main role of a fixed income allocation in a DC plan has been to generate income and provide diversification from equities. Up until this point, the average DC plan has almost exclusively utilized U.S. domestic bond funds for its fixed income allocation (Exhibit 5).

Exhibit 5: Utilization of Bond Funds in DC Plans

	% of Plans Offering	Avg. Participation Allocation
Domestic Bond Funds	98.0%	9.4%
International Bond Funds	4.0%	0.2%

Source: Vanguard — How America Saves 2013

Investors should be aware of the vulnerabilities of domestic fixed income in an environment where QE has ended and rates could rise. Under such a scenario, there are a number of prudent approaches and strategies to be considered as a means of hedging interest rate risk, including the use of a global fixed income or a low-volatility high-quality unconstrained strategy. With that said, some of the constituents of a global fixed income strategy (for example emerging market debt) are not practical standalone options for a typical DC plan; however, they may be appropriate additions to a white labeled global bond fund that is offered to participants.

If a more global framework is deemed appropriate for participants, plan sponsors can pool their existing funds and include sub-asset classes that are not suitable on a standalone basis into an appropriate global option, thereby increasing diversification, addressing manager concentration risk, and simplifying the decision-making process in one efficient step.

Tier I: Target Date Funds—Past and Present

The Pension Protection Act (PPA) of 2006 was instrumental in promoting plan design features such as auto-enrollment. The same act also included guidance around appropriate QDIAs for DC plans, providing plan fiduciaries a safe harbor default investment option.

As a result of these developments, we have seen the explosive growth of TDFs in DC plans since the passage of the PPA. Today, target date funds hold more than $670 billion in participant assets, more than four times the $160 billion at the end of 2008. Similarly, structured collective trusts for retirement plans at large companies hold an estimated $300 billion, putting the total size of the market at approximately $1 trillion[1].

The dynamic asset allocation of a TDF is known as a glidepath; its objective is to adequately control the combination of capital preservation, income generation, capital growth, and inflation protection assets according to a selected time frame, vintage, or "target date." As a general rule of thumb, the further removed from the target date (i.e., the more years until reaching the specified target date), we can expect to see a greater percentage of assets allocated to capital growth and inflation protection; the closer to the target date the greater the skew of the portfolio to capital preservation and income generating assets.

For example, in looking at some of the most widely-used target date fund families, a target date fund with a 2015 retirement year vintage will tend to have a higher weighting of its portfolio, say 50 percent or potentially more, allocated to capital preservation and income generating assets while a fund with a 2055 vintage should have a significantly lower amount (for instance, 10 percent) allocated to capital preservation and income generating strategies.

Within a streamlined investment structure, TDFs are viewed as a tier I "set and forget" fund option. By their very nature, target date funds are designed to help investors avoid some of the most common investment mistakes that are often highlighted in behavioral finance case studies, including:

- **Inadequate diversification —** TDFs avoid this by investing across a mix of asset classes.
- **Return chasing behavior, market-timing —** Target date funds follow professionally-designed, long-term (strategic) asset allocation models that are automatically rebalanced periodically to maintain their target asset allocations.
- **Inertia —** The target date portfolio is automatically adjusted for a changing risk profile. Therefore a participant will not be in overweight or underweight asset class exposures that are (in)appropriate for his or her specific time horizon.

Tier I: Target Date Funds — The Future

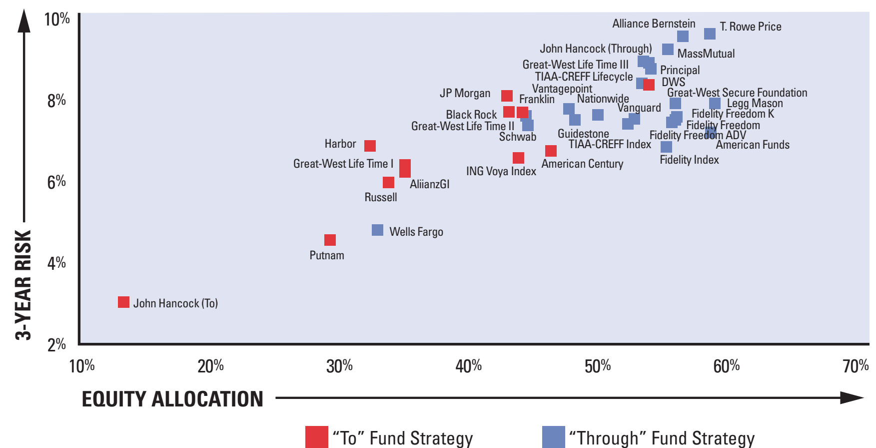
The main reason that a participant would select a TDF — "one-stop shopping" — is an extremely straightforward one. However, this same simplicity does not necessarily carryover to the fiduciary community when looking to add a TDF for the first time, or when monitoring the performance of lifecycle funds already in a plan.

Since there are many providers of lifecycle products in the marketplace, plan sponsors and their consultants cannot approach the decision to select or monitor an off-the-shelf target date fund family lightly. The broad availability of TDF products means there are many asset allocations, underlying managers, and glidepaths of target date funds from which to choose. A brief discussion with the most popular providers of target date products will highlight the fact that some providers place a higher priority on reducing volatility, current income, and preserving assets at retirement while others will emphasize higher returns post-retirement in an effort to tackle inflation and address longevity risk. Therefore, it is not surprising to see TDFs with the same vintage or retirement year reflect materially different risk profiles (Exhibit 6).

In addition to the different philosophies of constructing glidepaths, fiduciaries also need to be comfortable with whether a product offers a "to" retirement glidepath or a "through" retirement glidepath for participants. A "to" retirement glidepath will keep the target date fund's allocation to equities and fixed income static once the target year has been reached (usually with a higher allocation to fixed income) while a "through" retirement glidepath may start with a relatively higher allocation to equities once the target year has been reached, but then ratchet down in favor of fixed income each passing year.

Due to these issues just discussed — the diversity of off-the-shelf target date funds coupled with the "to" versus "through" debate — we have seen some plan sponsors move towards building their own custom target date fund products that better reflect the idiosyncrasies of their employee base (for

Exhibit 6: "To" and "Through" Target Date Fund Glide Paths

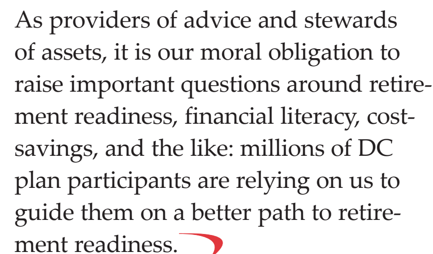


example building a more conservative glidepath over what is available in the marketplace for participants that are also covered by a pension plan during retirement). In addition to a tailored glidepath and a greater amount of control over the mix of underlying managers, some additional reasons for a custom TDF framework include potentially lower fees and additional asset classes for the underlying glidepath[2].

While we have seen increased demand for custom TDF products and expect to see greater utilization in the marketplace over the coming years[3], it is important to note that custom target date strategies will not be appropriate for all plan sponsors as their creation and maintenance may require extra third party resources to ensure that regulatory, fiduciary, and structural considerations are met on an ongoing basis.

Conclusion

In concert with the increased growth of DC plan assets, there have been many key developments in the areas of plan design and investment structure. At this point in the evolution of the DC story, it is important that consultants, plan fiduciaries, investment managers, and recordkeepers continue the trends and innovations in today's market. As providers of advice and stewards of assets, it is our moral obligation to raise important questions around retirement readiness, financial literacy, cost-savings, and the like: millions of DC plan participants are relying on us to guide them on a better path to retirement readiness.



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[1] Morningstar, Barrons

[2] Morningstar, Barrons

[3] We can point to several industry sources that also see the custom TDF solution growing for the foreseeable future. For example, Casey Quirk believes that custom TDFs will grow to represent 38% of all target date assets by 2018 while Cerulli believes that custom target-date fund assets in DC plans could rise by 370% from the $46.4 billion posted in 2011 and reach $218 billion in 2016. Though optimistic in magnitude, these examples are certainly indicative of growth of TDF solutions in the DC space.

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