Evolving Practices in Investment Line-up Construction

An overview of six investment trends.

By Lynda Sanderson

The Plan Sponsor's Dilemma

- Should we protect participants from bad outcomes, taking the steps to ensure they have assets for retirement, or
- Should we give participants investment choice, let them make their own decisions, and live with the outcomes of that choice?

Investment diversification is a fundamental responsibility for an ERISA fiduciary.

Defined contribution plan sponsors and fiduciaries are faced with a challenge. On the one hand, the objective for most plans is to give participants the opportunity to save enough money to live well in retirement. However, 401(k) plans have been around long enough to reveal that, left to their own devices, many participants do not take the actions necessary to ensure the best outcomes under these plans. On the other hand, 401(k) plans are designed and regulated to provide participants with self-directed choice, something about which participants can be quite vocal.

The resulting defined contribution environment has produced a spectrum of investment solutions for plans that are best-applied by considering:

- **Participant Populations** — their make-up, the level of investment knowledge generally present, and the way they use the plan;
- **Plan Sponsors** — specifically, the plan investment committee and its views and biases;
- **Environment** — from both a regulatory and a product development perspective.

A Little History

Over the past 30 years, there has been quite a bit of investment line-up development in the 401(k) space. In the early days of the 401(k), it was not uncommon to see plans with 3 investment options: an S&P 500 index fund, a GIC fund (i.e., what we now call stable value), and a company stock fund. As plans started to grow in asset size, mutual fund companies recognized the opportunity to grow their assets under management and drove expansion in investment line-ups by marketing to plans as investment-only and full-service (i.e., investment and recordkeeping) providers. The thinking then was that if a little choice was good, a lot must be better. As participant exposure to mutual funds in their 401(k)s increased through the late 1980's and early 1990's, they began to demand more choice, resulting in a virtual explosion in the number of investment options to 40, 50, or even 60 or more fund choices.

As plan sponsors, fiduciaries, and fund providers saw participants overwhelmed by too much choice (and realized the fiduciary burden of monitoring so many funds), plan sponsors pared down line-ups. Simultaneously, investment providers created target-date funds to automate investment best-practices of diversification, asset allocation, and regular rebalancing into one "do-it-for-me" option for participants overwhelmed by too much choice.

Today, evolution continues in investment line-ups, with both long-term trends still in implementation and newer trends just developing. An entire article could be spent on any one trend. However, here we will limit ourselves to an overview of six trends — 3 which have been developing over the last decade (and continue today) followed by 3 more recent trends which are just beginning to see implementation.

Trend One
Broadly-Diversified Options

For most plans this means target-date funds. Target-date funds have been around since the mid- to late-90's and have gathered an enormous amount of assets, generally comprising 10% to 30% of a plan's assets where they are one component of a diversified investment line-up. As the default option for most plans, this figure will likely only increase, making target-date funds a primary focus for most plan fiduciaries.

While these products may make investment decisions easier for participants, they add complexity for fiduciaries. The basic components of a target-date series — the glide slope and the underlying funds — give fiduciaries a good deal to understand and consider when trying to compare various options and select the one best-suited to their participant population. Recent developments in the target-date fund space have just added more variables. Newly modified glide slopes, the expansion of underlying asset classes to include many not typically found as stand-alone options in 401(k) plans, and the addition of tactical authority for target-date fund managers have only increased the complexity of the products as well as the difficulty of finding a basis for comparison among the various offerings.

Currently, the 401(k) market is well into the "second wave" for this product in the form of customized target-date funds. While the majority of plans still use packaged target-date products with the glide slope and underlying funds determined by the target-date fund provider, custom solutions continue to gain momentum — especially with larger plans. As the term implies, custom products allow for all the components (i.e., glide slope, underlying funds, asset class composition, etc.) to be structured to address the specifics of a participant population as well as plan sponsors' views. However, with the resources required for custom applications in terms of time, money, and expertise, they are not a realistic or efficient option for many plan sponsors to implement. Perhaps as a compromise, interest in a semi-custom approach to target-date exposure has been increasing through renewed consideration of allocation tools. Usually provided through the plan's recordkeeper, these programs apply asset allocation modeling based on professionally-created portfolios to the existing investment line-up in a 401(k) plan. Typically, these take age and risk tolerance into consideration to assign a target-date glide slope from a number of pre-determined options. For some plan sponsors, this can be an effective combination: control over the underlying investment components applied through a well-researched and professionally formulated and maintained glide slope solution.

Trend Two
Expansion of Index Funds

Gone are the days when plans offered an S&P 500 index fund as the sole index option. Many plan sponsors now offer a range of index funds to cover the investible market. This allows participants to create an individualized asset allocation strategy in a low-cost application.

As with target-date funds, there has been a second wave in this long-developing trend. With the expansion of the index fund line-up, many plan sponsors now view the role of the actively-managed options in the plan somewhat differently. Rather than looking for actively-managed funds designed to mirror or align with a specific benchmark, plan sponsors can consider funds with high-conviction, less benchmark-driven strategies where the underlying investment thesis is more distinctive. Essentially, by providing a full range of market access through indexed options, plan sponsors are free to also broaden the range of actively-managed strategies to provide a potentially different risk/return profile from the typical fund in the asset class, expanding the range of choices for participants.

Trend Three
Collapsing the Style Box

As investment options expanded in the 1990's, the conventional wisdom was to thoroughly cover the U.S. equity markets. This strategy typically resulted in at least 9 actively-managed U.S. equity fund options, often accompanied by a single non-U.S. equity option and one fixed income option. Over the past decade, plan sponsors have been moving away from slicing and dicing the U.S. equity market into multiple fund offerings to a more consolidated array of domestic investment options. In these instances, plan sponsors need to assess whether participants view the choice between value and growth strategies as an opportunity for diversification or for expressing an investment opinion or just as a way to have more buckets to fill. If it's the latter, why not consolidate into core options and use the resulting space in the investment line-up to offer participants more opportunity for diversification beyond the U.S. equity market?

Here, the second wave of this long-term trend is to expand the consolidation process from horizontally across investment styles to vertically across market capitalizations. For the most part, this means collapsing mid- and small-cap offerings into a SMID option, but some plan sponsors have considered the move to multi-cap funds. As with the consolidation of growth and value strategies, this is a step toward redefining the construct used to map out the investible markets, particularly in U.S. equities. Letting go of the traditional style-boxes for categories that make sense today enables plan sponsors to focus on filling the line-up with investment strategies that resonate with participants and the way they think about investing.

Trend Four
Taking a Global Approach

It has become conventional wisdom. We live in a global economy. With this more recent trend, investment line-up construction catches up with the expansion of the investible market. Throughout markets, lines are blurring (e.g., the distinction between developed and many emerging markets countries). Beyond that, how we define the jurisdiction of an equity holding is shifting. What really makes a firm a U.S. (or non-U.S.) holding — the location of its headquarters or where it generates its revenue? Further, the globalization trend now impacts corporations at all capitalization levels. Countries outside the U.S. have smaller businesses which afford investment opportunities, and even small-cap companies can have a global reach these days.

Today many plan sponsors agree that if they were starting from scratch with their 401(k) investment line-up, rather than focusing on a U.S. and non-U.S. distinction for funds, they would use strategies where the managers look for the best investment opportunities regardless of the country of domicile. However, since most fiduciaries are working with an existing line-up, this trend appears to be one that will be implemented opportunistically over time.

Trend Five
Adding Non-Traditional Asset Classes

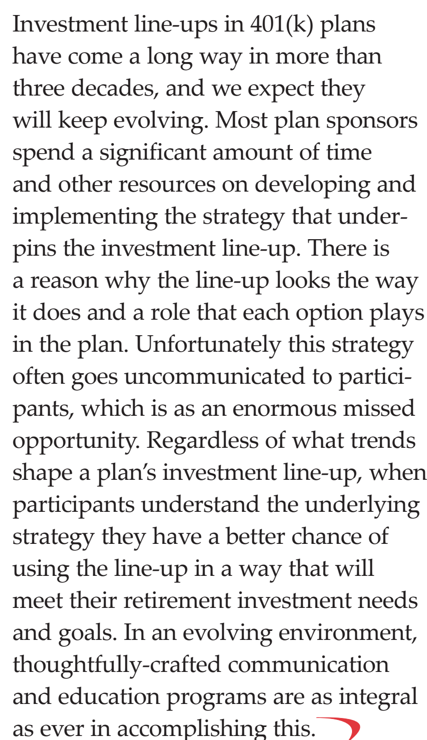
There was a time when including an emerging markets fund in a 401(k) plan investment line-up as a standalone option was deemed too risky. (What if a participant invested 100% in it?) While some plan sponsors are still reluctant to offer an emerging markets fund, others weigh the risk of inclusion against the diversification opportunity an emerging markets fund affords and see it as an integral part of a well-diversified investment line-up. As emerging markets funds have become more commonplace in 401(k) investment line-ups, some plan sponsors have turned their attention to new diversification opportunities.

Currently, “alternative” diversification opportunities can come in basic forms such as multi-asset real return strategies. Utilization of such strategies has been growing as plan sponsors have recognized that participants have a better understanding of overall investment goals than of specific asset classes. Rather than offering standalone REIT or TIPS funds, including a real return fund that allocates across REITs, TIPS, commodities, and possibly natural resource stocks, provides protection against potential inflation in addition to diversification benefits in a participant’s overall portfolio.

More complex “alternative” opportunities exist in hedge fund-like strategies where managers focus on producing only alpha by hedging out beta (i.e., market risk exposure) and aim to provide positive absolute returns regardless of the market environment. At the moment, utilization in 401(k) plans remains quite low for such strategies, largely due to lack of understanding by most plan participants and many plan sponsors. While plan sponsors may oppose offering such strategies as standalone options, there certainly exists opportunities for inclusion into customized target-date funds or asset allocation models. Lower correlations to traditional asset classes in absolute return products can help to make these existing multi-asset strategies more efficient on a traditional risk/return basis.

Trend Six
Adding Target Date Alternatives

As noted above, a target-date strategy is a fundamental part of almost every 401(k) plan today. Many participants appreciate the “once and done” decision that gets them diversification, asset allocation, and regular rebalancing. However, is the target-date strategy — whether it be through a packaged product or a customized approach — the best solution for every participant? Some plan sponsors are starting to think not. These fiduciaries are looking for other approaches to add to provide choice among “once and done” investment options. Whether it be through a global allocation fund that adjusts asset weightings based on strategic and tactical opportunities, a target return fund that focuses on a single long-term investment goal (e.g., CPI + 5%) with unconstrained asset allocation, or another construct, it’s an acknowledgment that an asset allocation glide slope may not necessarily be the best approach for every participant.



Communication and Education: Bringing It All Together

Investment line-ups in 401(k) plans have come a long way in more than three decades, and we expect they will keep evolving. Most plan sponsors spend a significant amount of time and other resources on developing and implementing the strategy that underpins the investment line-up. There is a reason why the line-up looks the way it does and a role that each option plays in the plan. Unfortunately this strategy often goes uncommunicated to participants, which is as an enormous missed opportunity. Regardless of what trends shape a plan’s investment line-up, when participants understand the underlying strategy they have a better chance of using the line-up in a way that will meet their retirement investment needs and goals. In an evolving environment, thoughtfully-crafted communication and education programs are as integral as ever in accomplishing this.

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