RETIREMENT PLAN INVESTMENTS

The evolution of investment options and menu design

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Objectives

• By the end of this webcast, participants will be able to
  – Identify industry trends and current and potential legislative issues affecting plans
  – Identify best practices for best fit investment menu design for their retirement plans
INVESTMENT TRENDS

Evolution of plan menu
Common themes

• ‘Scaled down’ investment choices
• Active vs. passive
• Qualified default investment alternative
• Target date funds
• Emphasis of investment fees
• Collective investment trusts (CITs)
EFFICIENT INVESTMENT MENU
Efficient menus create better outcomes

• Best ‘fit’ investment options for participants
• Too many choices, or “choice overload”, can lead to decision-making paralysis, anxiety and stress.¹
• A focused menu limits participant confusion and drives better participant outcomes.²
• Investment menu options are fewer in number, but broader in scope, allowing participants exposure to a broad array of asset classes.

¹The Paradox of Choice, Barry Schwartz
²Save More for Tomorrow, Shlomo Benartzi, UCLA Anderson School of Management, and Professor Richard Thaler, University of Chicago Booth School of Business.
Investment menu objectives

• **Drive** participant behaviors that are likely to create successful outcomes

• **Select** the most skillful managers within each investment discipline

• **Protect** plan fiduciaries

• **Minimize** employee confusion

• **Maximize** plan participation *and* at optimal levels

• **Provide** employees choice and flexibility
## Corporate culture and values

### Design
- Employee directed
- Virtually unlimited fund menu
- Self-directed brokerage

- Employee directed
- Focused fund menu
- Risk and/or age based asset allocation strategies
- Active strategies
- Passive strategies
- Cash investments

- Series of age-based asset allocation funds
- Employer directed based on participant age and other demographics

### Outcome
- Historically has resulted in poor participant outcomes

- Moves ‘the needle’ toward more successful outcomes for participants
- Still preserves the paradigm of employee choice

- May create the most successful and optimal outcomes for most participants
- Employers very reluctant to eliminate or reduce employee choice
Sample menu approach

Target Date Fund Series/ Risk Based Portfolios
A minimum of 5 funds (vintages) per risk appropriate glidepath

Active U.S. Equity

Passive/ Index Funds

5 funds

4 funds

3 funds
Sample menu approach, cont.

Investment menu options are fewer in number, but broader in scope, allowing participants exposure to a broad array of asset classes.
### Cash equivalent investments

<table>
<thead>
<tr>
<th>Type</th>
<th>Stable value</th>
<th>Money market</th>
<th>Guaranteed investment contract</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Return characteristics</strong></td>
<td>A reflection of portfolio’s assets</td>
<td>A reflection of short-term rates/yields</td>
<td>Set by company based on company’s assets</td>
</tr>
<tr>
<td><strong>Performance</strong></td>
<td>Will tend to outperform money market and guaranteed investment contract in a falling or low interest rate environment</td>
<td>Will tend to underperform stable value and GIC unless yield curves are flat or inverted</td>
<td>Will tend to outperform money market and stable value when interest rates rise and vice versa</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Contract limits immediate plan-level liquidity</td>
<td>Liquidity and lack of timing or market value adjustment (MVA) are attributes of this product</td>
<td>MVA may be positive or negative at termination</td>
</tr>
<tr>
<td><strong>Risk</strong></td>
<td>Has physical assets to support book value</td>
<td>Inflation risk</td>
<td>Risk of issuer bankruptcy</td>
</tr>
</tbody>
</table>
Investment policy statement

• Assists the plan’s fiduciaries by establishing guidelines for making investment-related decisions in a prudent manner

• Defines and establishes the:
  - Plan’s investment objectives
  - Roles and responsibilities of all parties
  - Criteria and procedures for selecting and monitoring investments
  - Corrective actions and procedures (if and when necessary)
  - Ways to comply with fiduciary obligations, applicable laws and regulations

• Structured enough to provide meaningful guidance

• Flexible enough not to force plan fiduciaries to make an imprudent decision
Our goal is to design the most efficient menu through the assessment and implementation of the factors below:

- Plan-specific demographics
- Plan objectives
- Behavioral research
- Institutional money management approach
- Investment policy statement
Active versus passive

• What’s the difference?
  – Active – manager discretion
  – Passive – track an index
  – Hybrid – portfolios, target date funds

• An ongoing debate for many years

• Most recent trend toward passive management
A passive trend: U.S. equity

U.S. Equity Active/Passive Percentage

A passive trend: U.S. equity dollars

Source: Morningstar Inc.
Note: 2018 data as of Nov. 30
A passive trend: Overall market

Why passive?

• Industry pressure on fees
• Active management performance
  – Struggle beating benchmarks
  – Consistently inconsistent
  – Too many options
• Long bull market
• Target date fund (TDF) usage
  – Nearly 95 percent of the net flows to TDF in 2017 went to TDF series that invest predominantly in index funds*

*Morningstar, “2018 Target-Date Fund Landscape” report
QUALIFIED DEFAULT INVESTMENT ALTERNATIVE
Qualified default investment alternative

- The Pension Protection Act (PPA) 2006 paved way for automatic enrollment, be invested in a qualified default investment alternative (QDIA)

- Four types of QDIA
  1. Life-cycle or targeted-retirement-date fund
  2. Professionally-managed account
  3. Balanced fund
  4. A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax)
TARGET RETIREMENT DATE FUNDS
Proliferation of target date funds

- $5.2 trillion in 401(k) plans as of 12/31/2018
- $1.77 trillion in target date solutions

1As of 12/31/2019
2 Investment Company Institute
*Source: Morningstar mutual fund data, Elston Consulting compilation and illustration © Elston Consulting Ltd. (UK)
Department of Labor Guidance – TDF tips

- Align TDF and participant characteristics
- Understand underlying investments
- Review fees and investment expenses
- Consider custom or non-proprietary options
- Develop effective employee communications
- Document the process
Process for selecting TDFs

Suitability analysis
- Funding adequacy
- Participant tendencies
- Glidepath risk postures

Qualitative considerations
- Active / passive
- Single manager / multimanager
- Asset class coverage

Performance analysis
- Risk / return comparisons
- Fund fees
- Underlying fund performance
The DOL recommends inquiring whether a custom or non-proprietary TDF would be a good fit for your plan.
Differences among TDF glidepaths

TDF equity allocations at retirement can vary by as much as 50%.

Data as of 1/31/2012. Source: Morningstar, Inc.
Past performance is not indicative of future results.
The multiple lines represent various TDF glidepath options available within the market place.
FEE TRANSPARENCY
What is fee transparency?

• Both plan sponsor and participants know who is getting paid what and how much
  – Disclosed on participant statements
  – 408(b)2 disclosure for plan sponsors

• No more hidden fees
  – Revenue sharing
  – Commissions
Revenue sharing

**Investment management**
A percentage of assets invested. Deducted from the return.

**Asset / wrap fee**
Additional fees layered on top of total investment fees.

**12b-1**
Paid by mutual funds from fund assets for broker commissions, marketing expenses and other administrative services.

**Shareholder servicing**
Revenue shared by the mutual fund company with the service provider.

**Sub-TA**
Recordkeeping and other services related to participant shares often go to a third party called a sub-transfer agent.
Why fee transparency?

• Fiduciary responsibilities and fees brought under a spotlight
• Confusion about fees
• Out of sight, out of mind
• Unlevelized costs
How do we get there?

• Remove revenue sharing completely
• Reimburse revenue sharing to participant accounts
• Fee levelization
  – Equal revenue sharing for all plan participants
COLLECTIVE INVESTMENT TRUSTS (CIT)
Collective investment trust

• Been around since 1927
• Bank product
  − Regulated by The Office of the Comptroller of the Currency (OCC) and DOL
• Exclusively for qualified retirement plans
• Similar to mutual funds, but with key differences
### Key differences

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Mutual fund</th>
<th>CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility</td>
<td>All eligible investors</td>
<td>Qualified plans</td>
</tr>
<tr>
<td>Regulators</td>
<td>SEC</td>
<td>OCC, DOL</td>
</tr>
<tr>
<td>ERISA fiduciary standards</td>
<td>No</td>
<td>Yes (CIT trustee)*</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Daily</td>
<td>Daily for DC participants</td>
</tr>
<tr>
<td>Governing docs</td>
<td>Prospectus</td>
<td>Declaration of trust</td>
</tr>
<tr>
<td>Fees</td>
<td>Determined by share class</td>
<td>Greater flexibility</td>
</tr>
<tr>
<td></td>
<td>May pay 12b-1 fees</td>
<td>No 12b-1 fees</td>
</tr>
<tr>
<td>Ticker/CUSIP**</td>
<td>Yes/Yes</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Reporting</td>
<td>Public performance information</td>
<td>Performance available through recordkeeper, by trustee/</td>
</tr>
<tr>
<td></td>
<td>available</td>
<td>manager and some CITs are reported on by Morningstar</td>
</tr>
</tbody>
</table>

*The sponsoring bank as trustee serves as fiduciary

**Committee on Uniform Securities Identification Procedures
CIT usage trending up

CITs have become a popular alternative to mutual funds within qualified retirement plans. Since 2012, CIT use has grown by 56 percent within DC plans, while the usage of mutual funds has decreased.*

*Callan 2017 and 2019 DC Trends surveys
Why CITs?

- Increased transparency and reporting
  - Daily valuation
  - Standardized and automated daily processing
  - Fact sheets and enhanced data reporting
  - Increased coverage (i.e. Morningstar, eVestment, etc.)
  - Standardized strategy, risk, performance and expense disclosures

- Availability shifting down market

- Increased investment choices
  - Available across all asset classes
  - Passive and actively managed
  - Target date funds

- Lower cost
THANK YOU FOR YOUR TIME AND ATTENTION