A Mission of Retirement Plan Investment Design:

"One Small Step" for the Plan Sponsor, "One Giant Leap" for Plan Participants

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Why Should Plan Sponsors Support a Mission of Investment Design?

Plan design auto features—automatic enrollment, automatic escalation, and even safe harbor match, to name a few—have been hot topics. But what about investment design? Investments fall into the plan's strategy when optimizing the retirement plan, and a carefully constructed investment menu can help participants maximize their retirement income potential. Unlike auto features and the added expense that comes with them, investment design benefits participants with little or no incremental expense by the participants or the plan sponsor.

Mission Checklist: Behavioral Economics Create a Blueprint for Effective Investment Design

Behavioral economics point the way to successful investment design. Much has been written about the topic of participant behaviors, but one behavior in particular—choice overload—is important to understanding effective investment design. Shlomo Benartzi (2012) notes this phenomenon in his book *Save More Tomorrow*, "…there is a growing body of research in psychology and economics (from laboratory experiments and real-world observations) indicating that there is such a thing as too much choice. Specifically, people find it easier to make decisions when faced with a small menu of options than with many possible choices." One of those studies by Iyengar, Huberman and Jiang (2004) discovered a negative correlation between participation rates and the quantity of funds in a defined contribution plan. A crowded plan menu can negatively impact how participants allocate their retirement savings across investment options. Iyengar and Kamenica (2010) report that participants tend toward lower equity exposure and higher cash equivalent exposure as fund choices increase.

Mission Control: Countdown to a Successful Launch Toward Participants' Retirement Goals

A focused investment menu is the "5...4…3…2…1…liftoff!" approach to investment portfolio design, constructing the plan's investment lineup so that participants can effectively "launch" toward their retirement goals while maximizing their retirement income potential. This investment design approach is as simple as it sounds: five target date funds (TDFs) by vintage per glidepath, four U.S. equity funds, three index funds, two fixed income funds and one international fund. Fewer options means employing broader investment mandates, which reduce choice overload and help better identify skillful active managers, directly affecting participant ending account balances—a successful "landing" at retirement. When building or reviewing a plan menu, consider this simple approach to streamlining plan design, while still offering participants everything they need to launch a robust portfolio.

5…to Mission Launch: Five Target Date Funds by Vintage per Glidepath

The foundation of a retirement plan consists of TDFs. They are an ideal selection for the vast majority of participants because they offer a single decision that leads to a diversified portfolio with optimized asset allocation and automatic de-risking as the participant approaches retirement. The first TDF in 1993 had only five vintages, offering five funds in 10-year increments. This approach remains optimal today but is in direct opposition to the industry's adoption of five-year increments, sparked by the desire to pinpoint a more precise retirement date. If only participants knew their exact retirement date! As a result, adding five-year increments has more than doubled the number of TDFs by glidepath, which could make sense if only participant demographics were homogenous

Most plans, however, exhibit diverse participant demographics. Even if participants know their exact retirement date, diverse demographics suggest different asset allocations for participants before, near, at and through retirement. Risk-based glidepaths, therefore, can be more meaningful than a single glidepath approach. For example, in 2008, the performance differential for 2010 retirement-dated funds ranged from -9 percent to -41 percent, a -32 percent difference. Allowing participants to match their retirement objectives to the appropriate glidepath significantly better aligns them with their retirement goals. Selecting an expected retirement date is only half of the equation. For most plans with diverse participant demographics, a TDF approach with 5 funds and only 10-year vintages leads to a better design of only 15 total funds (for a conservative, moderate and aggressive risk-based approach) than a single glidepath that may have as many as 15 funds in total but only 1 at retirement.

4…to Mission Launch: Four-Corners Approach with Four U.S. Equity Funds

Four active U.S. equity managers are optimal because they can cover the entire U.S. equity market. A four-corners approach utilizes active large-cap value, large-cap growth, small-cap value and small-cap growth funds. This approach focuses on the corners of the U.S. equity style boxes because alpha has historically been more attainable in these areas. Clearly defined styles increase our ability to identify skillful managers.. Adding mid-cap funds to a menu is redundant because large-cap and small-cap funds have imbedded mid-cap exposure. The average large-cap manager has 27 percent exposure to mid-cap stocks. Additionally, adding mid-cap funds offers little diversification benefit because the Russell Midcap Index and the Russell 1000 Index are highly correlated at .98.[1]

3…to Mission Launch: Three Pack of Index Funds—U.S. Equity, U.S. Fixed Income and International Equity

For participants seeking a low-cost index strategy, a three pack of index funds provides full coverage across the markets. A passive three pack includes a domestic equity fund, an international equity fund and a core fixed income fund. The Russell 3000 Index covers 98 percent of the U.S. equity market, the ACWI ex U.S. Index includes 22 developed international markets plus emerging markets and Barclays Aggregate Bond Index encompasses the primary sectors of the U.S. fixed income market, representing

over 9,000 securities. While the Russell 3000 Index is a broader index, an S&P 500 Index fund is also an adequate proxy for the U.S. equity market because it covers about 80 percent of the market and has a .99 correlation to the Russell 3000.[1]

2…to Mission Launch: Two Fixed Income Funds—Active Core Fixed Income and Stable Value

The primary fixed income option is core fixed income, which is a broad U.S.-focused fixed income strategy that allows portfolio managers to add value by diversifying across a broad array of fixed income securities that include government bonds, corporate bonds and mortgage-backed securities. This type of strategy offers participants the greatest diversification while maximizing yield for investors with an income focus. The average Morningstar Intermediate-Term Bond fund, for example, has 793 holdings (data as of 5/31/15). These broad based portfolios not only fully diversify participants, but can add incremental alpha when employing skillful managers.

Stable value is the second active fixed income option that should accompany a core fixed income option. For greater stability, the qualified retirement plan environment is unique in that it allows short-term bond strategies to be wrapped by insurance contracts, allowing for these stable value investment options. Stable value funds can provide more attractive long-term rates of return for investors than money market funds because the bond durations are typically greater than a year. The insurance contracts allow them to be benefit responsive, satisfying the cash equivalent function within a retirement plan, consistent with their primary goal of capital preservation.

1…to Mission Launch: One Active International Equity Fund

A single active international fund with broad-based exposure can add diversification with low correlation to the U.S. equity and fixed income markets and provide an additional source of alpha. Statistics show that 89 percent of large-cap international managers use a core MSCI benchmark as their primary prospectus benchmark and attempt to outperform the broader international equity markets rather than a certain style of benchmark. A single international fund can also provide adequate market cap and geographical diversification because the average international large-cap fund has 12 percent exposure to mid-cap and small-cap stocks and 5.2 percent exposure to emerging markets. With an expanded opportunity and less efficient markets, the international markets are an attractive area to take active risk.

Liftoff!

To achieve a successful liftoff in investment design, precise calculations are needed. Investment design can have broad-reaching implications before, during or after plan design auto features have been implemented. Successful investment design should not add any cost and can prevent unwieldy investment menus from creating participant choice overload that negates all auto feature benefits. Filling in every style box may look like adding value, and the plan sponsor may have requested such a strategy; however, the reality of the “every-style-box-is-covered” approach is that participants will likely

suffer from choice overload. Instead, it is time to start the 5...4…3…2…1 countdown to the liftoff of carefully constructed investment design that can help launch participants toward a successful retirement landing. By taking the "small step" of embracing behavioral economics and effective investment design, plan sponsors help participants take the "giant leap" of meeting their retirement goals.

Source:

1. MPI three-year correlation as of 3/31/15; http://www.russell.com/documents/indexes/us-index-comparison.pdf.

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