



## INVESTMENT MENU DESIGN: BEST PRACTICES FOR DEFINED CONTRIBUTION PLANS



# THE MULTNOMAH GROUP

EMPLOYERS TURN TO THE MULTNOMAH GROUP FOR THE BEST  
IN RETIREMENT PLAN AND INVESTMENT CONSULTING SERVICES  
AND A RELATIONSHIP BASED ON TRANSPARENCY AND TRUST



*We welcome the opportunity to present to you.*

## SCOTT CAMERON, CFA

Scott is the Chief Investment Officer for the Multnomah Group and a Founding Principal of the firm. In that role, Scott leads Multnomah Group's Investment Committee, is responsible for the development of the firm's investment research methodology, and conducts investment manager due diligence. Scott also consults with plan sponsors on investment menu design, investment manager selection, fiduciary governance, and vendor fees/services.

Scott is a member of the CFA Institute, the CFA Society of Portland, the Investment Management Consultants Association, and the Portland Chapter of the Western Pension Benefit Conference.



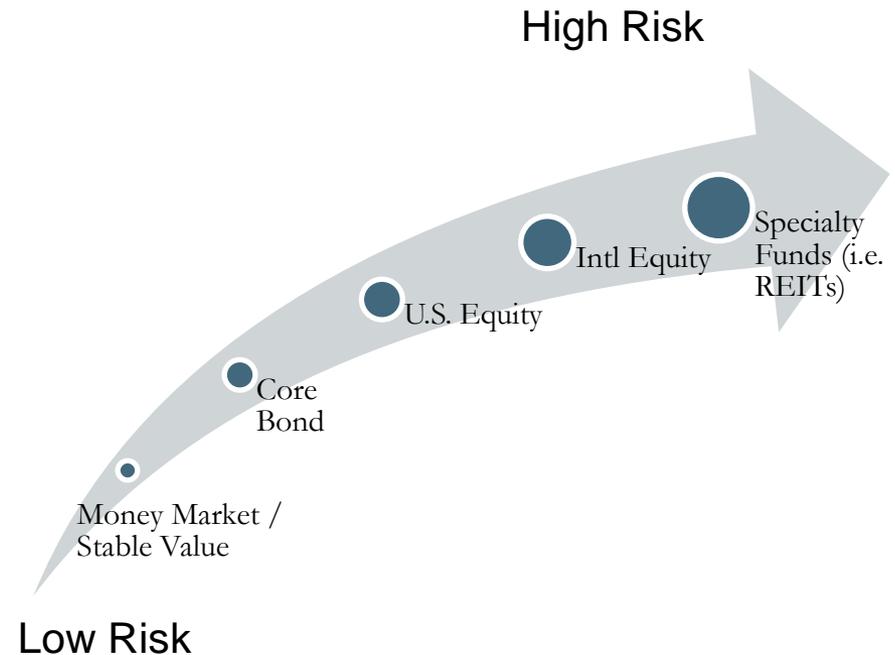
# AGENDA

- Evolution of Defined Contribution Plans
- Plan Sponsor Best Practices
- Target Maturity Investment Products
- Options for Low Risk Investors



# DC INVESTMENT LINEUPS: OLD PARADIGM

- All participants are active investors
- More choices lead to better portfolios
- Fiduciary focus on 404(c) protection
- Focus on investment products/manager analysis
- Vendors compared on features



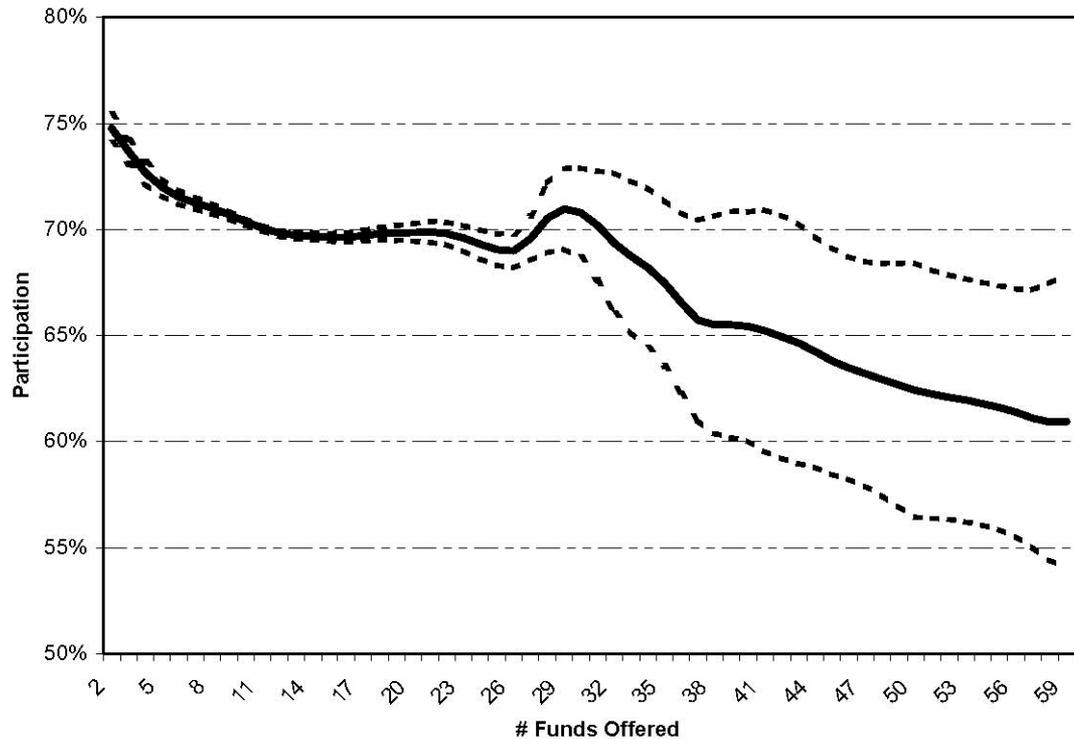
# IS THE OLD PARADIGM EFFECTIVE: THE EVIDENCE

Participant Type	How Participants Self-Identify
Delegators	69%
Do-It-Yourselfers	30%
Self-Directed Sophisticates	1%

Source: J.P. Morgan Retirement Plan Services

# IS THE OLD PARADIGM EFFECTIVE: THE EVIDENCE

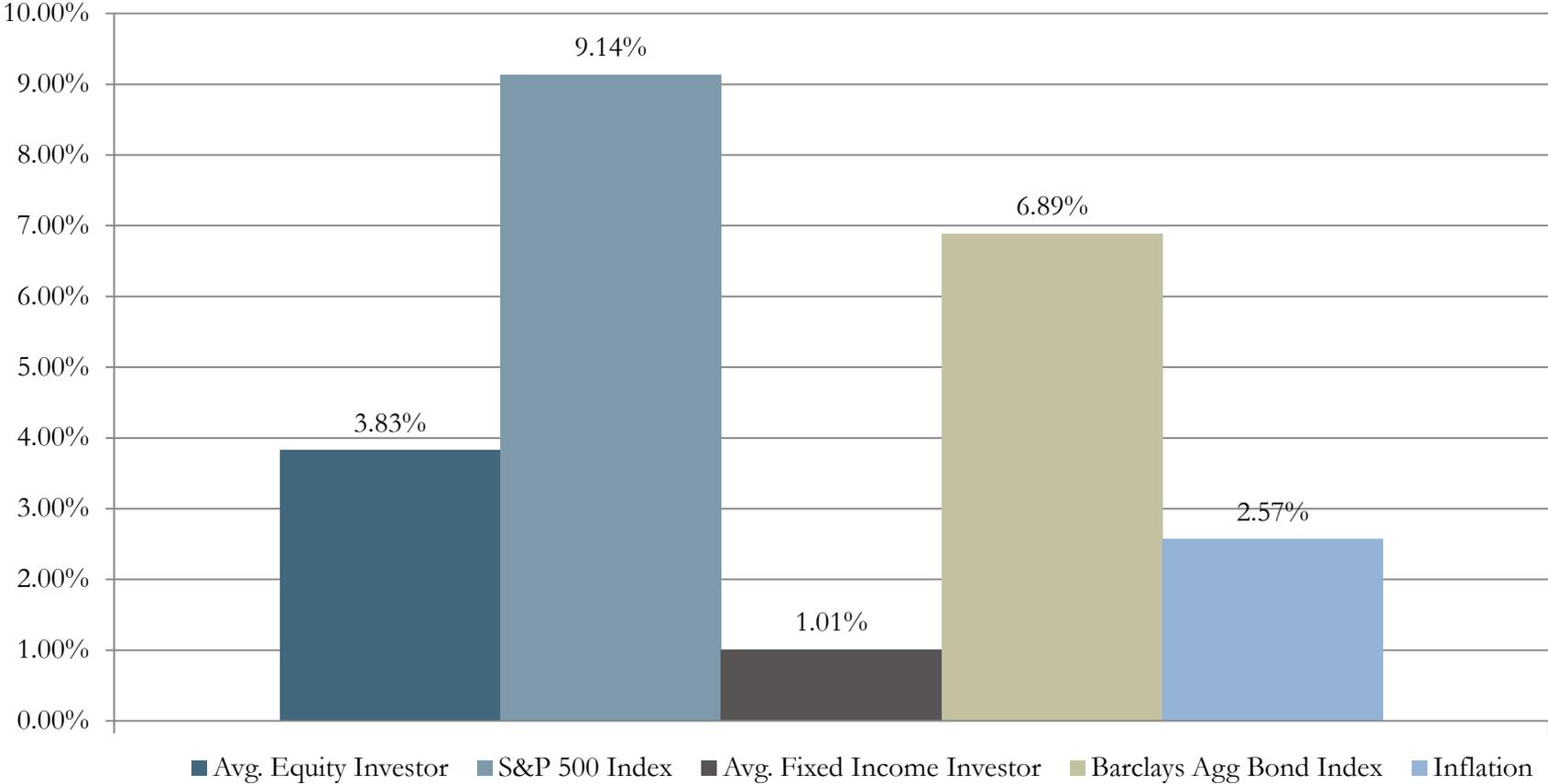
## Impact of Choice on Participation Rates



Source: Iyengar, Sheena S.; Jiang, Wei; Huberman, Gur "How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans"

# INVESTORS FAIL TO TRACK THE MARKET

Annualized Returns for the 20 Years Ended 12/31/2010



Source: Dalbar, Inc. 2011 Quantitative Analysis of Investor Behavior

# DC INVESTMENT LINEUPS: NEW PARADIGM

- Not all participants are the same
- Incorporate behavioral finance knowledge into retirement programs
- Fiduciary focus on participant outcomes
- Focus on menu construction
- Vendors compared on solutions

Tier One

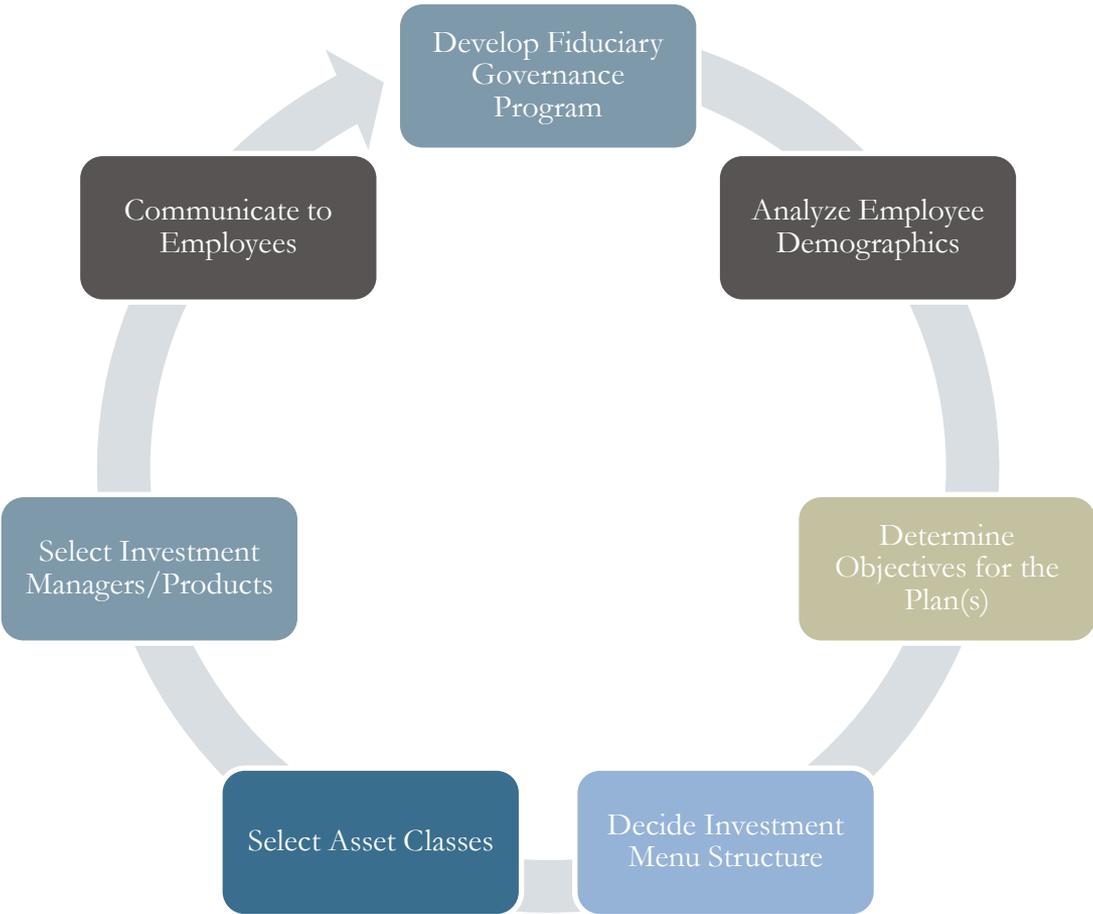
Tier Two

Tier Three

# THE PARADIGM IS SHIFTING

- Pension Protection Act of 2006
  - Automatic enrollment
  - Qualified Default Investment Alternatives (QDIA)
- J.P. Morgan – “Focus your AIM: Innovating the Defined Contribution Core Menu to Help Increase the Odds of Participant Success”
- Manning & Napier – Two-Tier Menu Design
- Schwab Retirement Plan Services Inc. - Launches Schwab Index Advantage
- Vanguard – “Converging Trends Drive Sponsors to Change Plan Lineups”

# PLAN SPONSOR BEST PRACTICES



# ANALYZE EMPLOYEE DEMOGRAPHICS

- Relevant Information
  - Age
  - Income
  - Tenure
  - Financial Literacy
  - Participant Opinions
- Methods
  - Anecdotal/Experience
  - Vendor Demographic Reports
  - Payroll Data
  - Participant Surveys
  - Focus Groups

# DETERMINE PLAN OBJECTIVES

- Retirement Readiness
- Income Replacement is Best Measure
  - General rule of thumb is 70%-80% of final year's salary
  - Can vary based on lifestyle, income, etc.
- Be Careful of Measurement Issues
  - No one is “average”
  - Shortfall risk is important

# DECIDE INVESTMENT MENU STRUCTURE

- Tiered Methodologies are Preferable
- Simplifies Decision-Making
  - Employee communication is clearer
  - Decision-making is easier
- Offers Meaningful Choices to Participants
  - Acknowledges participants are different
  - No one-size-fits-all choice is available
  - Participants want different options

# INDEX TIER OPTION

- Ability to Build Globally Diversified Index Portfolio
- Low Cost
- Broad Diversification
- Style Specific Actively Managed Funds for Active Participants
- Optional Self-Directed Brokerage Account for Most Active Participants

Asset Allocation Funds (i.e. Target Maturity, Target Risk, etc.)

Core Index Funds

Active Style Funds

(Optional) Self-Directed Brokerage Account / Mutual Fund Window

# SAMPLE INDEX TIER

## Tier 1: QDIA

## Tier 2: Core Index Array

Stable Principal	Fixed Income	U.S. Equity		International Equity	
Money Market	Intermediate Bond	U.S. Stock		International Stock	

## Tier 3: Core Active Array

Stable Principal	Fixed Income	U.S. Equity		International Equity		Specialty Funds
Fixed Annuity	Active Intermediate Bond	Large Cap Value	Large Cap Growth	Large Cap Value	Large Cap Growth	REIT
	Inflation Protected Bond					
	Global Bond	Small Cap Value	Small Cap Growth	International Small Cap		

## Tier 4: Self-Directed Brokerage Account

# MULTI-MANAGER CORE TIER OPTION

- Core Array Consisting of Multi-Manager Portfolios
  - Money Market/Stable Value
  - Equity
  - Fixed Income
  - (Optional) Other Categories
- Core Strategies Incorporate Multiple Sub-Asset Classes
  - Small Cap
  - REITs
  - Emerging Markets
  - High Yield
  - Global Bond
- Core Strategies Incorporate Open Architecture Managers

Asset Allocation Funds (i.e. Target Maturity, Target Risk, etc.)

Core Multi-Manager Strategies

(Optional) Self-Directed Brokerage Account / Mutual Fund Window

# TIER 1 – ASSET ALLOCATION STRATEGIES

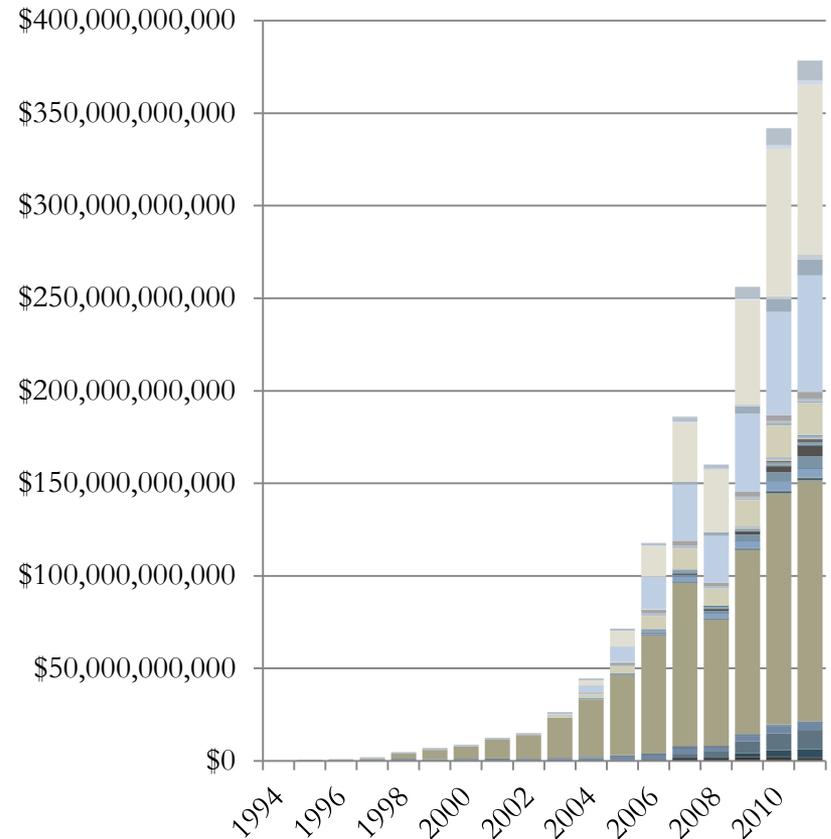
- Tier 1 is Typically the QDIA or QDIA-Type Option
  - Target maturity or target risk
  - Fund or model portfolio
- Target Maturity Funds are Most Common
  - Simplicity in design

## 5 Year Annualized Returns (Period Ending 12/31/2010)

Percentile	Single Target-Date Fund	Managed Account	All Other Participants
Mean	3.93%	3.65%	3.76%
5 <sup>th</sup>	3.62%	2.20%	-0.02%
25 <sup>th</sup>	3.62%	3.08%	2.66%
50 <sup>th</sup>	3.90%	3.66%	3.80%
75 <sup>th</sup>	3.90%	4.22%	4.64%
95 <sup>th</sup>	4.65%	5.06%	8.09%

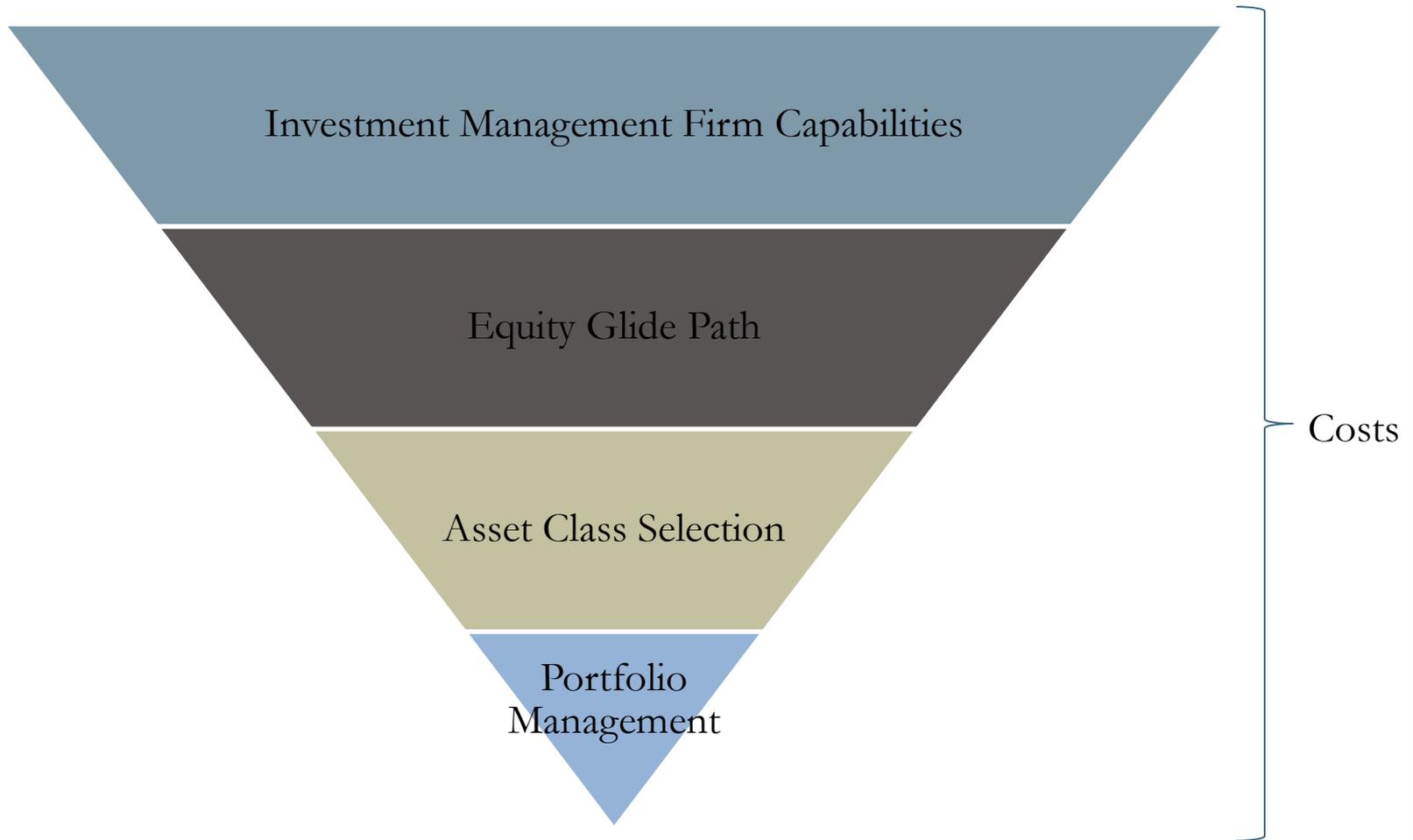
Source: Vanguard 2011 "Participants During the Financial Crisis: Total Returns 2005-2010"

## Growth of Target Maturity Products



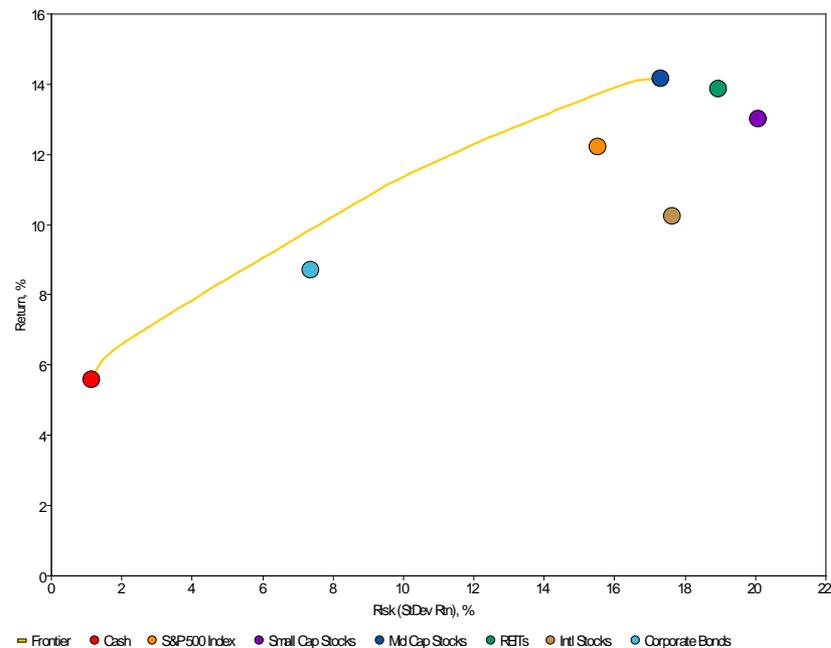
Source: Morningstar Direct

# TARGET MATURITY SELECTION CRITERIA



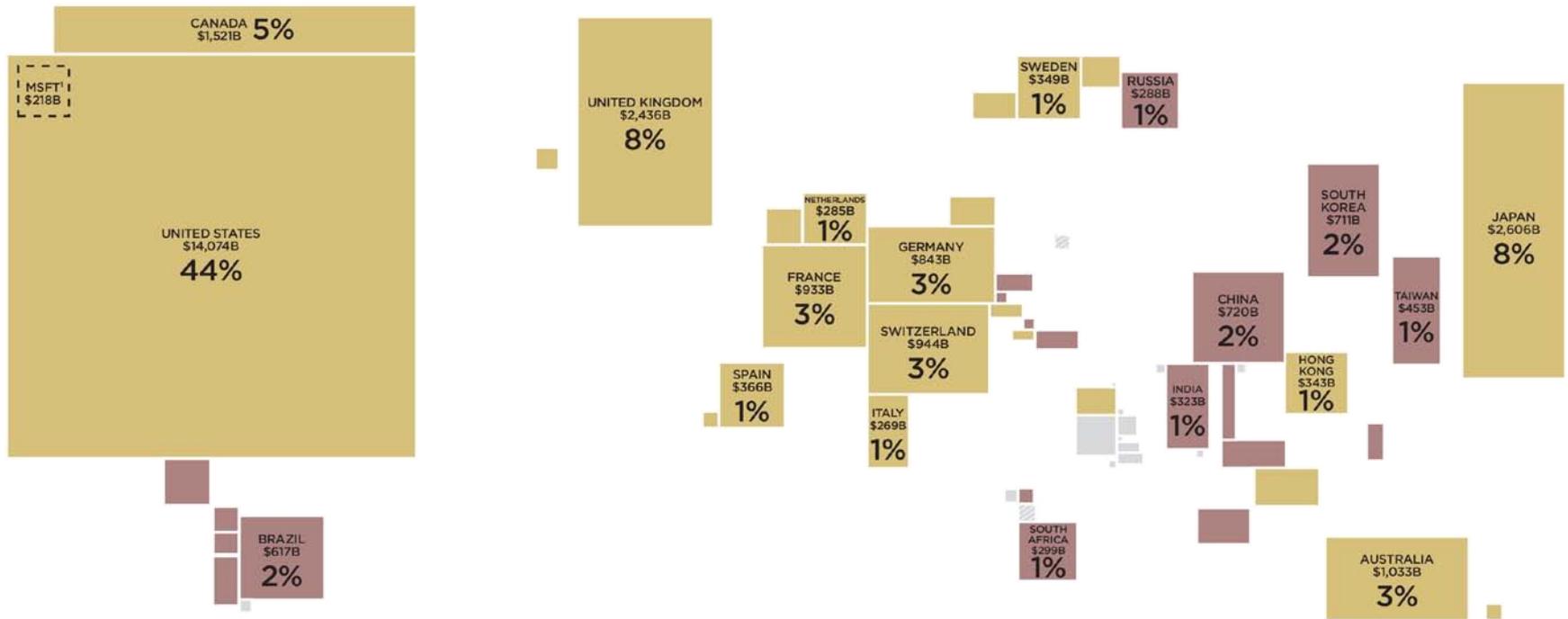
# SELECT CORE ASSET CLASSES

- Objectives
  - Provide participants with the ability to create a diversified portfolio tailored to their specific risk tolerance and time horizon
  - Allow participants to diversify their holdings among a number of different asset classes with different risk and return profiles
  - Utilize low correlated asset classes to minimize the amount of risk at any given return profile
- Constraints
  - Minimize opportunity for participants to select undiversified portfolios with unrealistic return and risk expectations
  - Avoid narrowly defined “asset classes” with risks that are difficult to identify



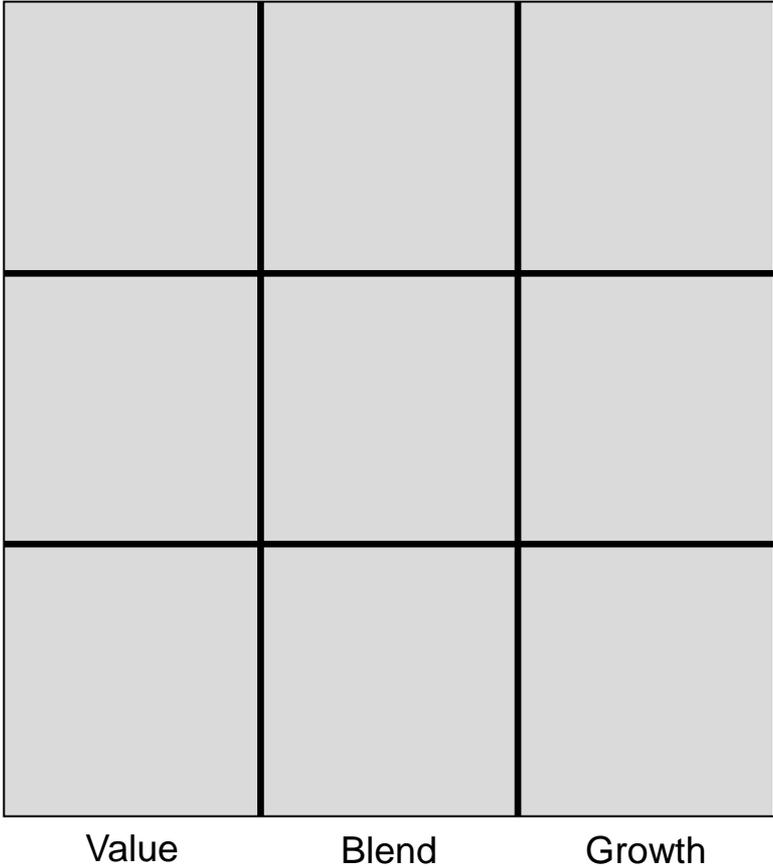
# GLOBAL MARKET CAPITALIZATION

\$31.7 Trillion as of December 31, 2011

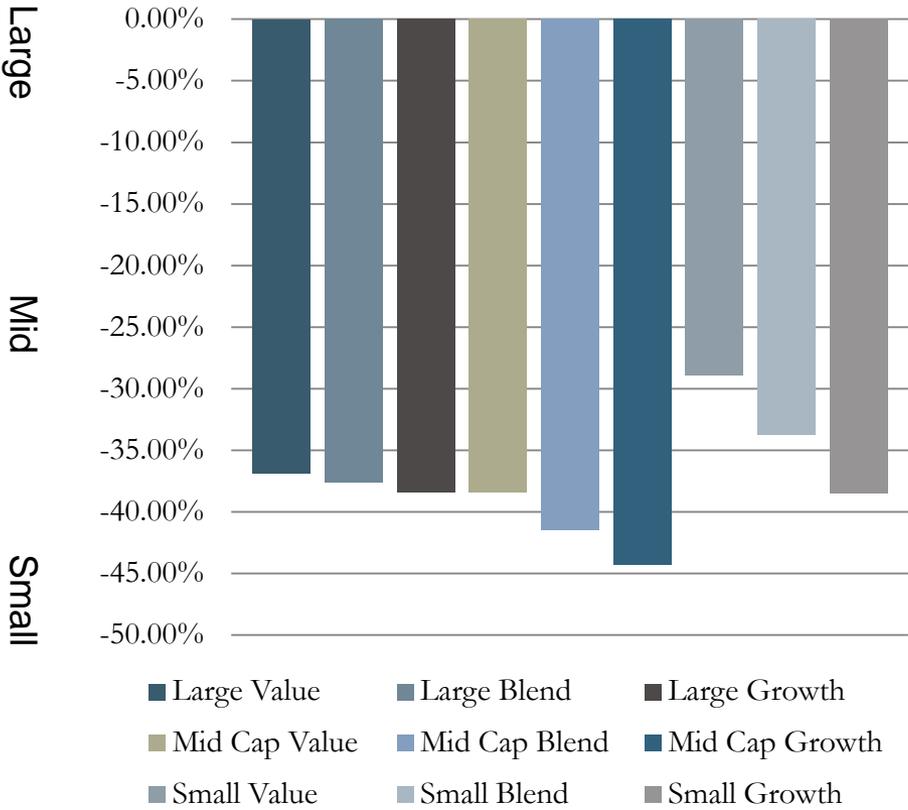


Source: Dimensional Fund Advisors; In US dollars. Market cap data is free-float adjusted from Bloomberg securities data. Many small nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. 1. An example large cap stock provided for comparison.

# STYLE BOXES & ASSET CLASSES

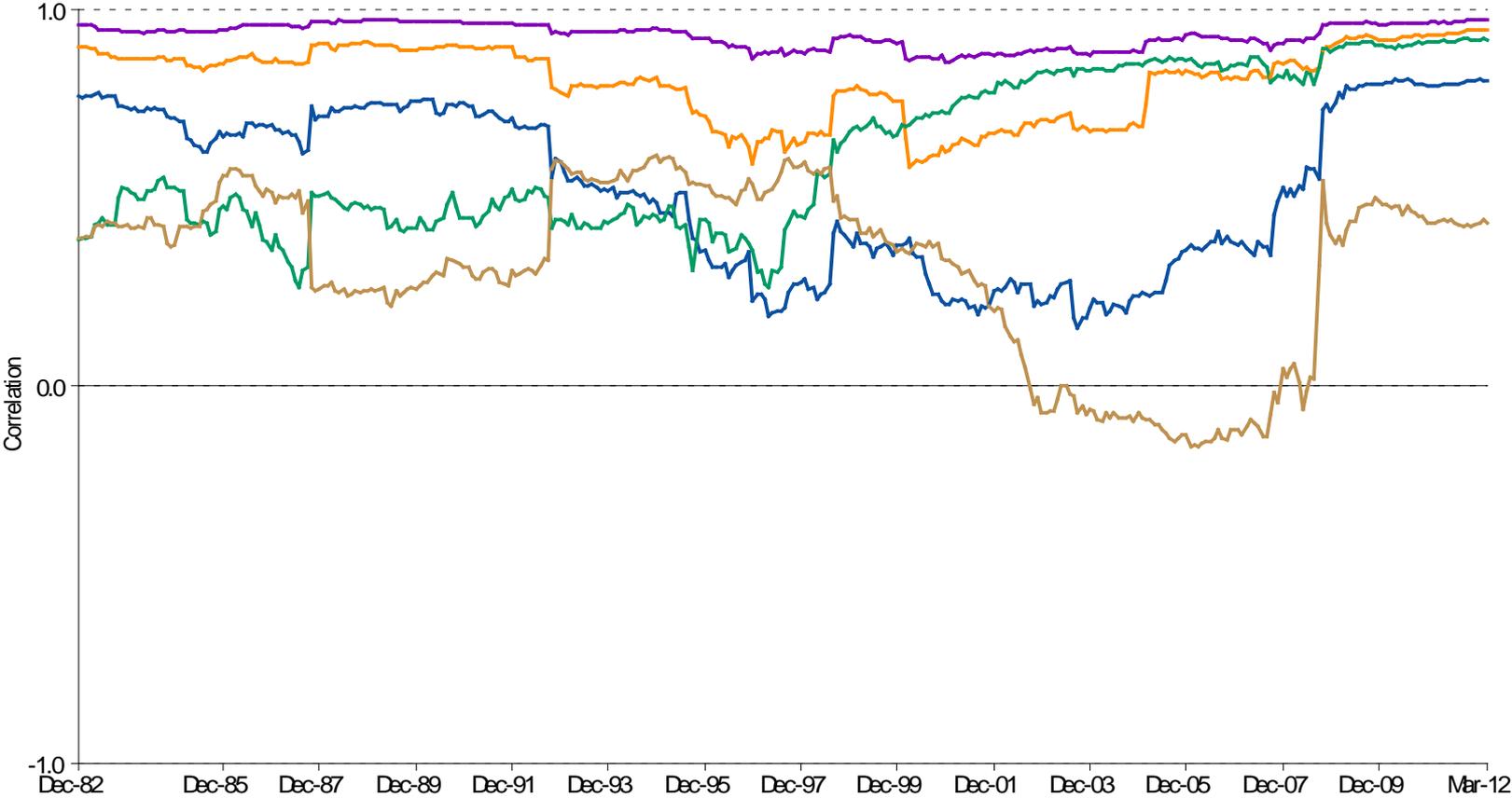


Calendar Year Returns (2008)



# DIVERSIFICATION IS TRICKY

## Correlation to the S&P 500 Index (Rolling 60 Month)

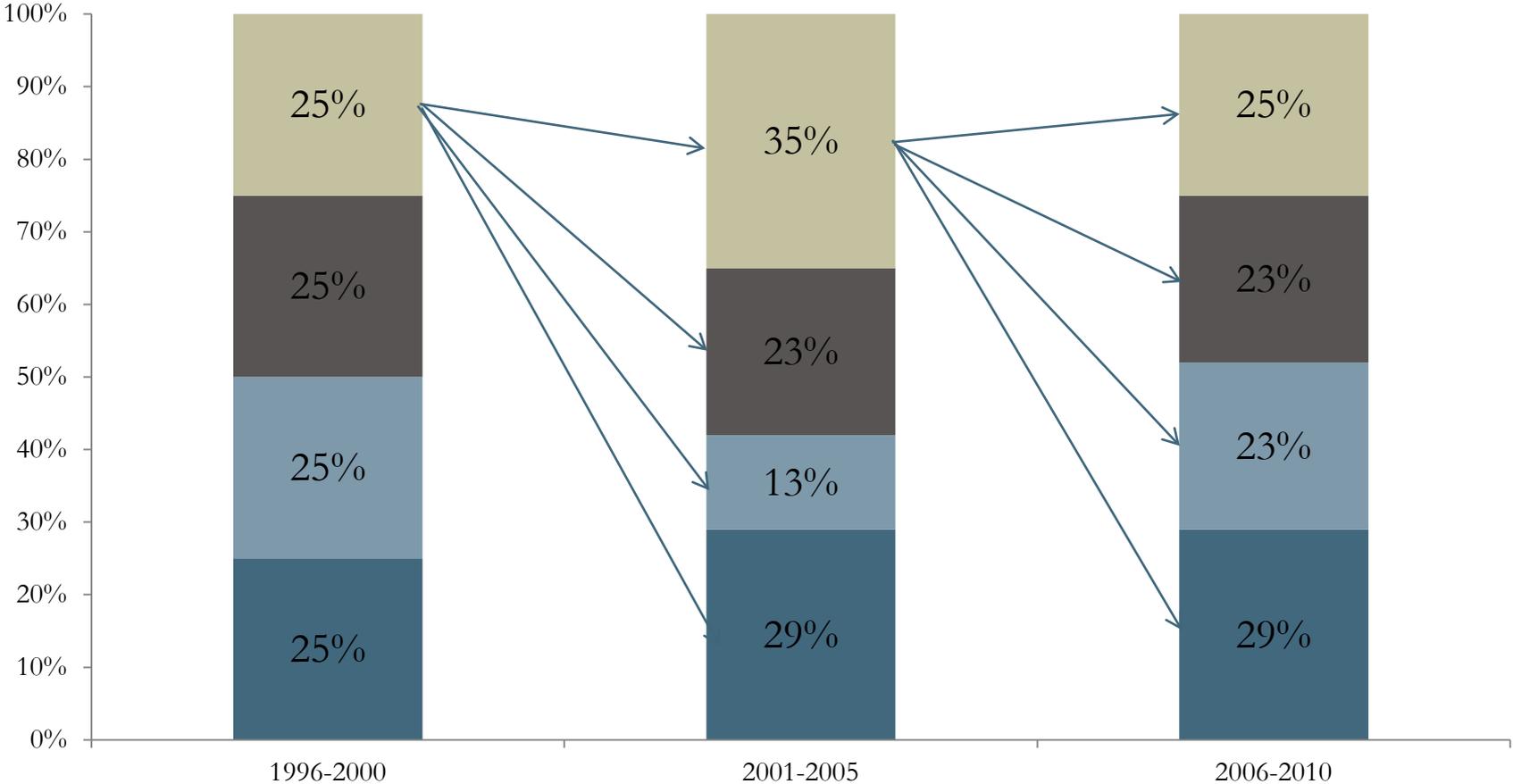


Small Cap Stocks = Russell 2000 Index; Mid Cap Stocks = Russell MidCap Index; REITs = Dow Jones US Select REIT Index; Intl Stocks = MSCI EAFE; Corporate Bonds = BC Corporate Idx

# SELECT INVESTMENT MANAGERS/PRODUCTS

- Pre-Determine Investment Manager's Role in the Menu
- Understand the Investment Manager's Investment Philosophy
  - Source of Value-Added
  - Types of Market Environments That Create Headwinds/Tailwinds
- Evaluate Historical Performance in the Context of Investment Philosophy

# MANAGER PERFORMANCE DOES NOT REPEAT



Source: Morningstar; 190 funds with 15 year track records

# COMMUNICATE TO EMPLOYEES

- Benefits
  - Demonstrates meaningful choices to participants
  - Minimizes “choice overload”
  - Simplifies participant decision-making
- Challenges
  - Standard vendor communications don’t always support tiered investment menus
  - Vendor websites are not structured to support tiered investment menus
  - Tiered menu communications are usually tailored for proprietary investment products

# LOW RISK INVESTMENT OPTIONS

## Option 1

Stable Value  
Fund

Intermediate  
Bond

## Option 2

Money Market

Ultra Short  
Term Bond

Intermediate  
Bond

## Option 3

Money Market

Short Term  
Government  
Bond

Intermediate  
Bond

## Option 4

Money Market

Short Term  
Bond

Intermediate  
Bond

# STABLE VALUE FUNDS FACE MARKET PRESSURE

- Consolidation of stable value providers
  - Higher costs/lower capacity will continue to squeeze providers
- More expensive wrap insurance will bring new entrants into the market
- Low interest rate environment
  - Improved MV/BV ratios
  - Stable value funds have only existed during a period of steady, declining interest rates
  - Increasing rate environment will put pressure on MV/BV ratios
  - May also cause higher levels of participant transactions as participants try to arbitrage return differentials
  - Money market funds react more quickly to yield changes (may outperform stable value for a period of time)
- Back to the future
  - Use of more traditional GICs/separate account GICs with synthetic GICs portfolios
  - Bundling of wrap insurance with investment management
  - Increased usage of traditional GICs and separate account GICs by plan sponsors

# QUESTIONS?

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