Evaluating Target Date Funds

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Agenda

- Overview of Qualified Default Investment Alternatives
- Survey of the Target Date Fund Universe
- Department of Labor Guidance on Target Date Funds
- Selection Methodology
- Ongoing Evaluation Methodology
- Questions

Qualified Default Investment Alternatives

- Originated with the Pension Protection Act (PPA) of 2006
- DOL's objective was "…to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker's long-term retirement savings needs."
- Final regulation outlined four categories of products that qualify as QDIA
  - A product with a mix of investments that takes into account the individual's age or retirement date.
  - An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date.
  - A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual.
  - A capital preservation product (for only the first 120 days of participation).
- QDIA regulations create a safe harbor for plan sponsors meeting guidelines
- Safe harbor does not eliminate the requirement for plan sponsors to prudently select QDIA option

Source: Employee Benefits Security Administration "Regulation Relating to Qualified Default Investment Alternatives in Participant-Directed Individual Account Plans", April 2008

Target Date Fund Universe

- First product launched in 1994
- At the end of 2003 there were 16 target date fund series
- Now there are 58 target date mutual fund series from 40 different investment management firms
- Universe expands if you include Collective Investment Trust (CIT products)

Target Date Series	Assets (millions)	Market Share (%)
Vanguard	$280,332.4	31.8%
Fidelity Investments	$192,912.9	21.9%
T. Rowe Price	$148,007.7	16.8%
American Funds	$53,637.4	6.1%
JPMorgan	$44,770.7	5.1%
TIAA-CREF Asset Management	$31,339.4	3.6%
Principal Funds	$26,114.2	3.0%
American Century Investments	$17,025.2	1.9%
John Hancock	$16,331.1	1.9%
BlackRock	$11,679.3	1.3%
Other	$58,295.6	6.6%
Total	$880,445.9	100.0%

Source: Morningstar 2017 Target Date Fund Landscape; Assets as of 12/31/2016

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Department of Labor Guidance

www.dol.gov/ebsa/pdf/fsTDF.pdf

- Establish a process for comparing and selecting TDFs
- Establish a process for the periodic review of selected TDFs
- Understand the fund's investments – the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time
- Review the fund's fees and investment expenses
- Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan
- Develop effective employee communications
- Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection
- Document the process

One Problem: Not All Target Date Funds are the Same

- Investment Objectives
  - Maximize retirement savings
  - Replacement of minimum level of income
- Glidepath
  - To vs. through retirement
  - Initial equity allocation
  - Equity allocation at retirement
  - Terminal equity allocation
- Asset Allocation
  - Traditional vs. non-traditional assets
  - Inflation-risk management
- Investment Management
  - Active vs. passive investment strategies
  - Proprietary vs. open-architecture sub-advisors

Selecting Target Date Funds: A Prudent Process

Evaluate Plan Preferences
- Plan Demographics
- Plan Design
- Committee Philosophy

Conduct Investment Due Diligence
- Firm Capabilities
- Investment Personnel
- Investment Philosophy/Process

Select a Series
- Expenses
- Platform Availability

Step 1: Evaluate Plan Preferences

Evaluate Plan Preferences
- Plan Design
- Plan Demographics
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Evaluate Plan Preferences

Plan Demographics

- Financial Literacy
- Average Age
- Average Income
- Average Deferral Rates
- Use of TDFs as Sole Investment
- Likelihood of Retirement at Age 65
- Stickiness of Plan Assets in Retirement
- Aptitude to Convert to Lifetime Income at Retirement

Plan Design

- Auto-enrollment
- Auto-escalation
- Availability of Defined Benefit Plan
- Availability of Lifetime Income Tools

Committee Philosophy

- Plan Objectives
- Traditional vs. Non-traditional Asset Classes
- Market Risk vs. Longevity Risk
- Minimize Downside vs. Maximize Upside
- Inflation Risk
- Active vs. Passive
- Proprietary vs. Open-architecture

The Moving Parts of Target Date Funds

Glidepath Structure	How does the equity glidepath change as the portfolio approaches the target retirement date?
	What are appropriate levels of equity or growth-oriented asset exposure at different points in the glidepath?
Landing Point (To vs. Through)	At what point in an investor's lifetime should the target date fund reach its terminal equity allocation?
	For how long should an investment manager continue to reduce equity exposure into retirement?
Non-Traditional Asset Classes	To what extent should the investment manager allocate a portion of the TDF portfolios to non-traditional asset classes?
Active vs. Passive	For the underlying investments within the target date fund series, should the investment manager primarily use passive or active investment strategies?
Proprietary vs. Open Architecture	For the underlying investments with the target date fund series, should the investment manager primarily use proprietary or non-proprietary investment strategies?

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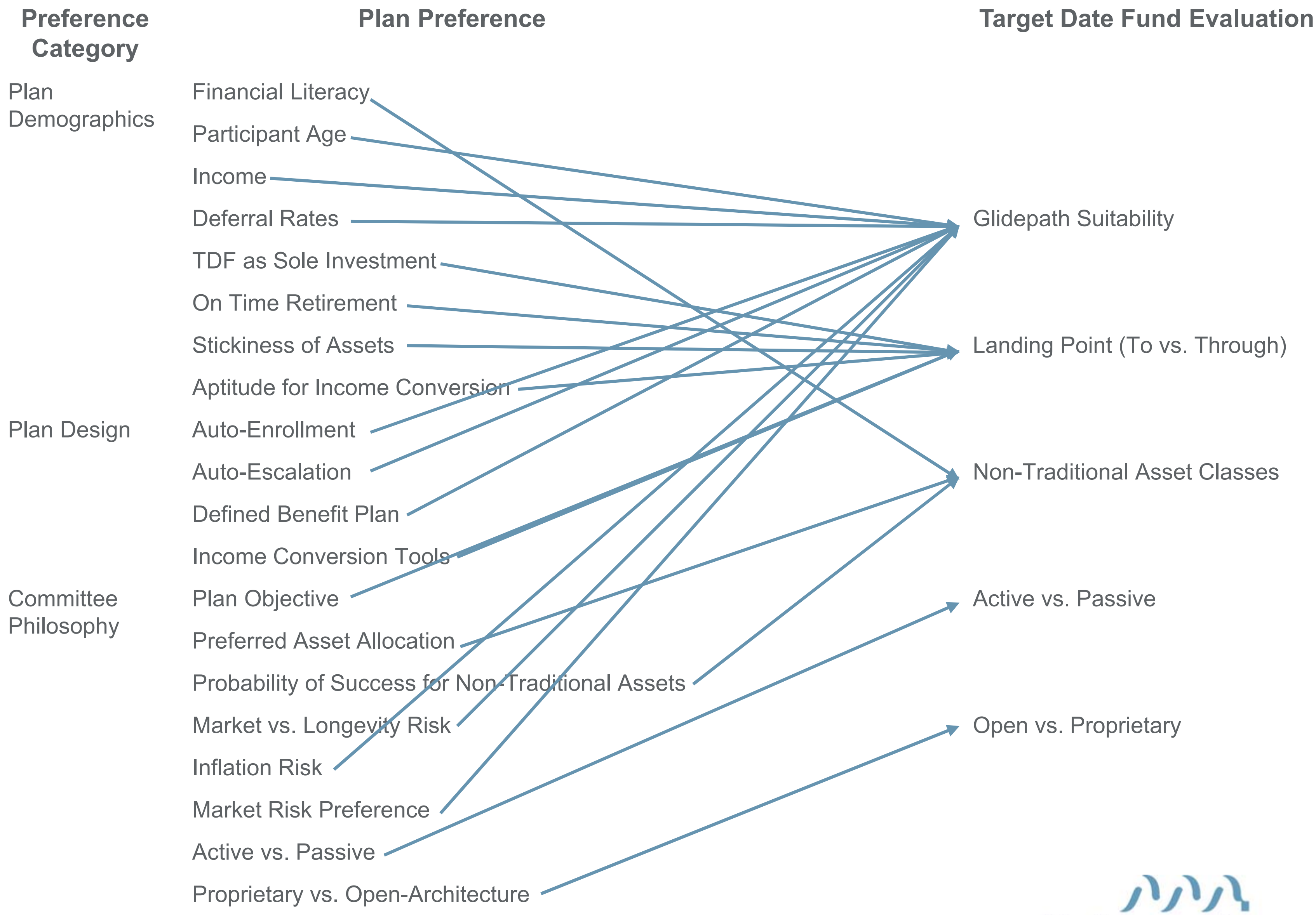
Plan Preferences Impact Target Date Fund Suitability



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Weighting of Plan Preferences on Target Date Fund Suitability

Glidepath Suitability	Landing Point (To vs. Through)	Non-Traditional Asset Classes	Active vs. Passive	Open vs. Proprietary
Market vs. Longevity Risk				
Inflation Risk				
Market Risk Preference				
Auto-enrollment	Income Conversion Tools			
Auto-escalation	Plan Objective			
Defined Benefit Plan	TDF as Sole Investment			
Deferral Rates	On Time Retirement	Preferred Asset Allocation		
Income	Stickiness of Assets	Probability of Success for Non-traditional Assets		
Participant Age	Aptitude for Income Conversion	Financial Literacy	Active vs. Passive	Proprietary vs. Open-architecture

Step 2: Conduct Investment Due Diligence

Evaluate Plan Preferences
- Plan Design
- Plan Demographics
- Committee Philosophy

Conduct Investment Due Diligence
- Firm Capabilities
- Investment Personnel
- Investment Philosophy/Process

Select a Series
- Expenses
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Investment Manager Firm Capabilities

- Target date funds shift responsibilities to the fund manager from the participant
  - Asset allocation is the responsibility of the fund manager
  - Security selection is the responsibility of the fund manager
- Transitioning responsibility to the fund manager requires the plan sponsor to gain deeper understanding of the investment management firm
  - Firm stability
  - Experience
  - Commitment
  - People
  - Process
  - Resources

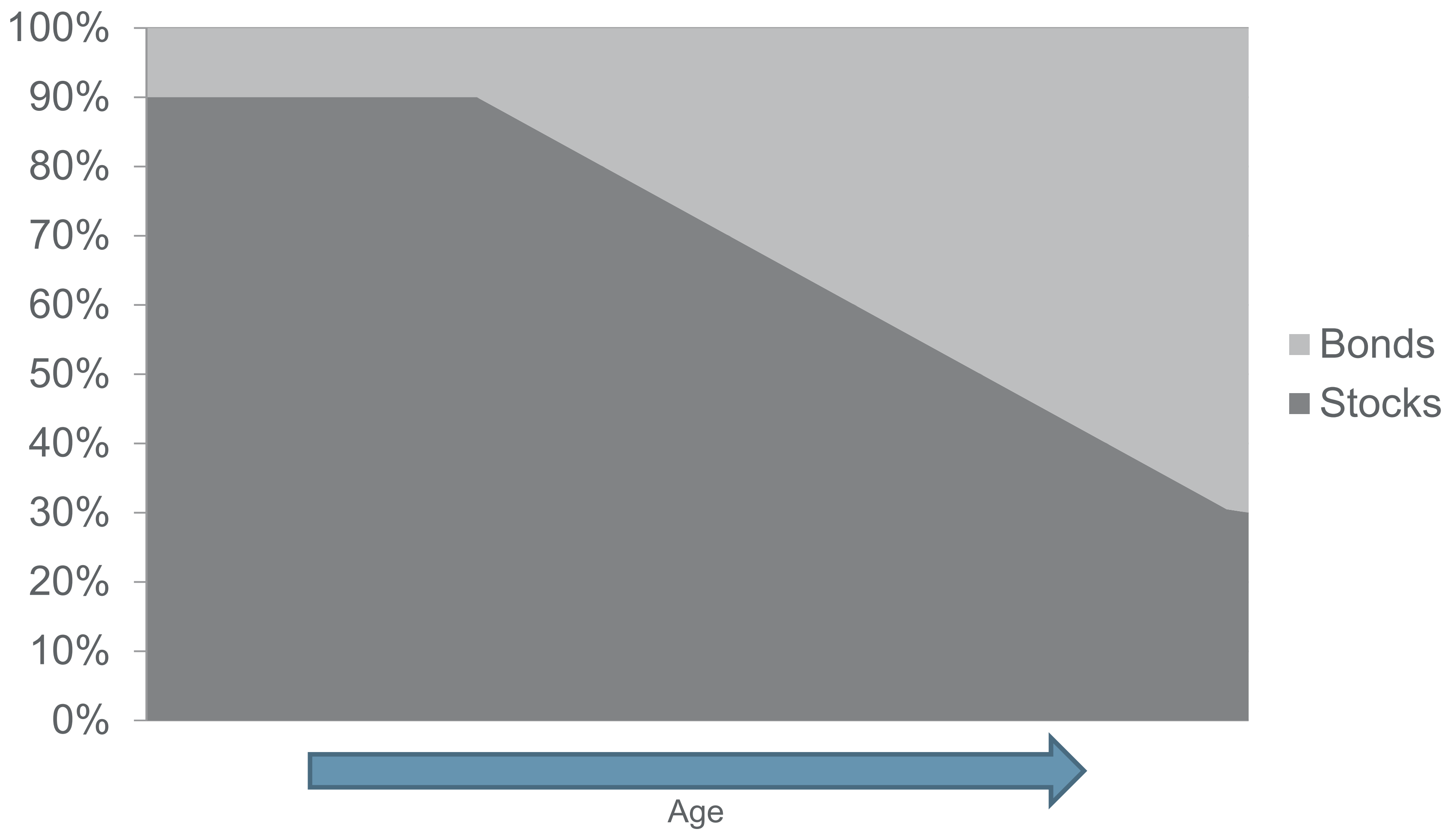
Firm Evaluation Criteria

- How stable is the organization?
  - Target date funds are designed to last a participant's lifetime (40-70 years)
  - Funds need to grow and adapt during that time period
    - New asset classes
    - Changing market dynamics
    - New investment research
  - Plan sponsors desire lower turnover of target date fund products compared to core fund options
- What experience does the firm have in creating global asset allocation portfolios?
  - Most investment management firms are successful because of their single asset class funds
  - "Manager skill" is in selecting individual securities
  - Types of experience that is relevant
    - Outsourced pension investing
    - Investment consulting
    - Target risk investing
    - Target date investing
  - Is the asset allocation work done internally or outsourced to a third-party?

Firm Evaluation Criteria (cont.)

- Commitment
  - Does the firm have a dedicated staff for managing the target date funds?
  - Are the target date funds a core product for the fund manager?
  - Have the products shown sufficient traction in the market to support long-term viability?
  - Does the fund manager demonstrate thought leadership within the target date universe?
- People
  - What experience do the portfolio managers have with asset allocation funds?
  - How long have they been managing target date products?
  - Do they have any other responsibilities within the firm?
- Process
  - Do they have a process for evaluating changes to the target date funds?
  - Have they managed investment products before?
  - Do they have a defined process for managing cash flows?
  - How do they handle rebalancing?

Equity Glidepath



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To Retirement

Investment Theses

- Human-capital thesis
  - Maintain static risk exposure regardless of time horizon
  - Future earning and Social Security are bond-like
  - As an investor ages the present value of their future earnings declines so their financial capital (retirement account) should be adjusted to increase their bond exposure
- Observed behavior thesis
  - Participants are not as rational as the forecast models imply
  - Analysis of actual 401(k) participant behavior indicates large withdrawals at or near retirement
  - Greater uncertainty at the end-point
  - Objective is to get participants to the end-point rather than all the way through retirement

To Retirement (cont.)

Glidepath Impacts

- Reaches its most conservative allocation at the retirement date
- Generally more conservative allocations in the near retirement years
- Funds merge into static allocation product at expected retirement year

Through Retirement

Investment Theses

- Mean-reversion of assets
  - Time horizon is most important factor to analyze
  - Equity risk is minimized over longer time periods
  - Investors at retirement still have long time horizons
- Equities are necessary to counter longevity risk
  - Market risk (volatility) is weighed too heavy relative to longevity and inflation risk
  - Higher equity exposure is necessary to provide sufficient retirement

Through Retirement (cont.)

Glidepath Impacts

- Equity allocation continues to decline after the target retirement date until sometime post-retirement (5-20 years after retirement date)
- Equity allocations are generally higher at retirement date when compared against “to retirement” funds
- Participants maintain their age-specific fund past the retirement date

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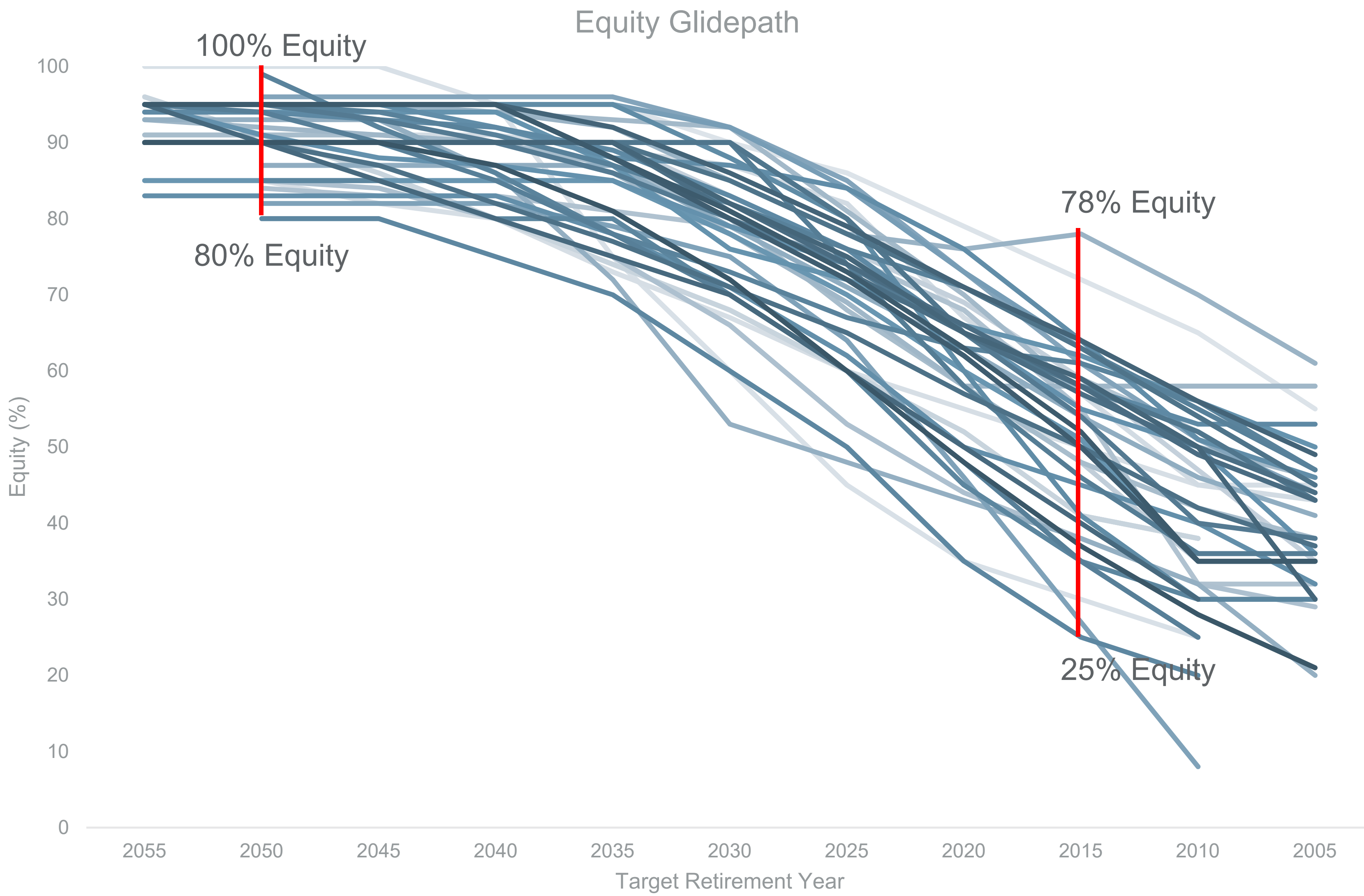
Target Date Stock Allocations



Source: Morningstar

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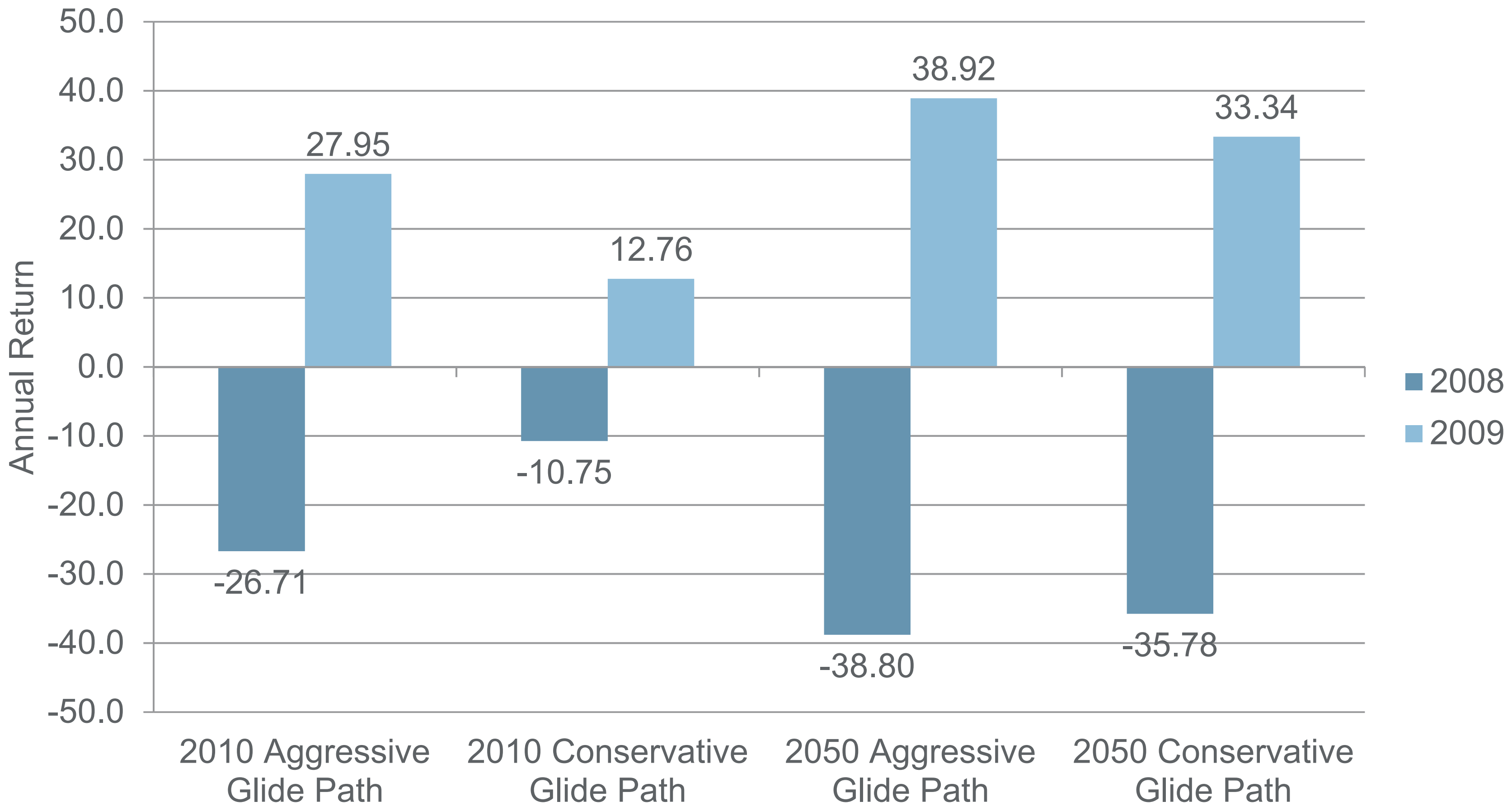
Impact of Glidepath on Performance



The Aggressive Glidepath represents T. Rowe Price Retirement funds and the Conservative Glidepath represents Wells Fargo Dow Jones Target Retirement funds.

Asset Class Considerations

- Which asset classes are included in the target date funds?
- Do the funds provide sufficiently broad exposure to global capital markets?
- How did the fund manager determine which asset classes would be suitable for inclusion within the funds?
  - What modeling was done to determine the appropriate mix of asset classes?
  - Did the fund manager utilize capital market assumptions in their modeling?
    - Historical data?
    - Forecasted data?
  - What impact do the fund manager's investment products play in determining asset classes?
    - Were asset classes excluded because the manager lacked a product?
    - Were asset classes included solely because a manager has a product in that class?
- How frequently does the fund manager review the asset class structure of the funds?
  - Have there been any recent changes in the asset classes utilized by the funds?
  - Are they evaluating any future changes to the asset class lineup?

Asset Class Components

Standard Asset Classes	Portfolio Diversifiers (Return Enhancement / Risk Reduction)	Real Return Hedges
Cash	Stable Value	TIPS
Intermediate Bonds	High Yield Bonds	Commodities
Large Cap U.S. Equities	Global Bonds	Real Estate (REITs or Direct-Owned)
Small/Mid Cap U.S. Equities	Preferred Stocks	Natural Resource Stocks
International Equities	Small Cap International Stocks	
	Emerging Market Stocks	
	Volatility	

Impact of Asset Classes on Performance

	2008 Return	2010 Fund A Portfolio Weight	2015 Fund B Portfolio Weight	Difference
Cash	2.06%	9.30%	0.00%	-9.30%
BC Credit Index	-3.08%	11.80%	4.01%	-7.79%
BC Government Index	**12.39%**	5.84%	22.35%	**16.51%**
BC Mortgage Backed Secs Index	8.34%	0.00%	8.13%	8.13%
BC High Yield Corporate Bond	-26.16%	15.79%	2.90%	**12.89%**
Russell 3000 Index	-37.31%	**42.06%**	**49.87%**	7.81%
DJ US Select REIT	-39.20%	1.98%	0.00%	-1.98%
MSCI EAFE	-43.38%	13.24%	12.84%	-0.40%
Total Return	**N/A**	**-30.27%**	**-24.06%**	**-6.21%**

Portfolio weights are calculated using a returns-based style analysis method using returns for the 36 months ended 12/31/2010

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Active / Passive Investment Management

Active Portfolio Management	• Seeks to outperform a benchmark • Value added through the manager's skill in timing the market or selecting securities • Higher costs create a hurdle for the manager to outperform on a net-of-fees basis
Passive Portfolio Management	• Seeks to provide market rates of return • Portfolios try to track benchmark indices by replicating or sampling the index • Lower cost for portfolio management
Hybrid Portfolio Management	• Utilizes a combination of active and indexed strategies • May lower total cost of fund (not necessarily true)

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Active / Passive Management Considerations

Active Management

- Evaluate usual criteria for selecting active “core” managers
  - People
  - Process
  - Investment Philosophy
  - Costs
  - Capacity
- Active management adds a layer of risk to the target date series
- What is the process for selecting the active managers?
- How does the target date fund manager evaluate the managers?
- What happens if a manager underperforms?

Passive Management

- Evaluate the usual criteria for selecting index managers
  - Costs
  - Experience
  - Tracking error
- Does the target date fund provider have access to a broad enough set of index strategies to provide the asset class exposure that is desired?

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Proprietary vs. Open Architecture

Proprietary Investment Management	Open-Architecture Investment Management	Hybrid Strategies

• All of the underlying portfolios are managed by the target date fund manager
• Most prevalent form of target date funds
• May create perceived conflicts between the target date fund investors and the fund manager
• May expose investors to highly correlated alphas
	• Target date fund managers utilizes outside portfolio managers to handle the security level portfolio management responsibilities
	• Not very common
	• Open-architecture funds are more commonly structured as collective investment trusts (CITs)
	• Adds an additional level of fees to the funds
	• Open-architecture does not guarantee higher performance
		• Sub-advised portfolios
		  • Fund manager utilizes sub-advisers for a portion of the portfolio
		• Multi-boutique portfolios
		  • Target date fund sponsor has multiple independent investments teams
		  • Each team maintains its own independent investment research/strategy

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Ongoing Monitoring Methodology

- Has anything in our initial analysis changed?
- Is the fund behaving consistent with expectations given the market environment?
- Are the portfolio managers adding value?
- How do these products compare to alternatives in the market?

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