



DEFINED CONTRIBUTION INVESTMENTS ON TRIAL

—
In Defense of an Institutional Approach

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involve risk, including possible loss of capital.



EXECUTIVE SUMMARY

There is significant debate as it relates to the appropriate investment approach for defined contribution plans. Now more than ever, plan sponsors are faced with a unique set of challenges when it comes to helping participants meet their retirement goals. The growing dependence on participant-directed retirement savings vehicles, elevated market valuations, and heightened employee financial stress, coupled with increased fiduciary scrutiny, are among key concerns for plan sponsors. For example, in reaction to fiduciary concerns, it was found that almost 50% of plan sponsors choose passive investment options to alleviate the threat of litigation or because it is easier to monitor.¹

In this paper, we make a case for why adopting an institutional approach in investment design, relative to a simple approach, is crucial for improving retirement outcomes for participants. By making this shift, plan sponsors will be more equipped to meet fiduciary responsibilities, encourage a mindset towards financial wellness, and practice fairness. More importantly, plan sponsors should adopt the approach used by their institutional peers in building investment solutions if they want to be successful at helping participants meet their retirement liabilities and manage key risks.



INTRODUCTION

In the Defined Contribution (DC) space, there is significant debate as it relates to the appropriate investment approach in helping participants build and manage retirement savings. The various approaches are being “litigated” in deliberations at committee meetings, at conferences, in the court of public opinion including by individuals and the media, and in actual courtrooms through class action lawsuits. While there are a spectrum of solutions and many plans do not fall squarely in any one category, the three broad approaches under scrutiny are:

1. The Retail Approach

- **Primary Focus:** Appealing to what is believed participants want
- **Typical Applications:** A wide-array of choice; emphasis on name recognition

2. The Simple Approach

- **Primary Focus:** Minimizing fees and maximizing simplicity
- **Typical Applications:** Heavy or exclusive use of passive management; basic asset classes

3. The Institutional Approach

- **Primary Focus:** Solutions that are believed to offer a higher probability of meeting a desired outcome
- **Typical Applications:** See chart to the right (Figure 1)

Here, we will make the “case” for an institutional approach from investment, fiduciary, wellness, and fairness perspectives. This approach can be applied both to the lineup that is offered to participants and, more importantly, how the default option such as the target-date fund is constructed.

Starting in the latter half of the 1990s, the retail approach was in vogue, with investment menus exploding in terms of number of options and with an emphasis on name-brand funds, often using expensive share classes. However, this resulted in “damages” to participants who were overwhelmed with too much choice and tended to pay higher fees than required. While plans often still have vestiges of this approach, many today are now focusing on offering basic and cheap investment choice. Unfortunately, this simple approach is “guilty” of leaving participants overexposed to market risk, under-diversified, subject to opportunity costs, and without solutions to complex issues such as retirement income, potentially putting retirement outcomes at risk as a result.

Leading plan sponsors are taking a more institutional approach. To define what an institutional approach means, look to other institutional pools of assets, such as Defined Benefit Plans, Endowments, Sovereign Wealth Funds, Insurance Company General Accounts, sophisticated Wealth Management Platforms, and Family Offices. Characteristics of how these investors

Figure 1

Characteristics of an Institutional Investment Approach	Application Within Defined Contribution Plans
Outcome-oriented investments	Target-date funds, stable value, retirement income solutions, and managed accounts
Broad asset class diversification	Extended credit sectors, private assets, absolute return, and real assets
Best-of-breed investment management	Skilled investment managers that are institutional in nature
Thoughtful mix of active and passive	Hybrid target-date strategies and customized open-architecture funds
Vehicle agnostic	Institutional mutual funds, collective trusts, and separate accounts

deploy capital include a focus on outcome-oriented investments, broad asset class diversification, use of best-of-breed investment management, a thoughtful mix of active and passive, and taking a vehicle-agnostic approach. For DC Plans, this approach can be implemented in different ways, but ultimately it is making sure investments are offered to participants with the objective of meeting their retirement liabilities and managing key risks.

However, we are not naïve enough to think that DC plan menus are constructed in a vacuum. Sponsors must balance building institutional DC menus with unique participant needs and behaviors, as well as fiduciary concerns – both real and perceived. Yet, we believe the “evidence” is clear that adopting an institutional mindset is imperative to driving successful outcomes for participants.



THE INVESTMENT CASE

The primary case for an institutional approach is the investment case. This case rests on improving risk-adjusted performance to help participants better meet their objectives – what any institutional investor should ultimately be seeking. If one cannot make this case, the others are moot. Methods to increase risk-adjusted returns should focus on both the return side (through the thoughtful use of active management, attractive asset classes, and using scale to reduce fees) and the risk management side (through manager and asset class diversification).

Most institutional portfolios incorporate exposures to traditional market beta (passive management) as well as smart beta and alpha (active management), striking the right balance of cost, risk, and return for the given asset class. Traditional market beta provides investors with low cost access to a specific market, but only by accepting market performance and risk. The simple approach stops here. In a more institutional approach, alpha exposure can be obtained through active management, but the cost of potential positive active return is higher. So why pay the higher fee? Simple analysis shows that if a participant can achieve just 35 basis points (0.35%) of net return annually over a benchmark across a lifetime of saving and spending, their assets can last an additional 6 years in retirement.² That is a meaningful outcome that seems worthy of trying to achieve for the benefit of one's workforce. But how does one go about doing that?

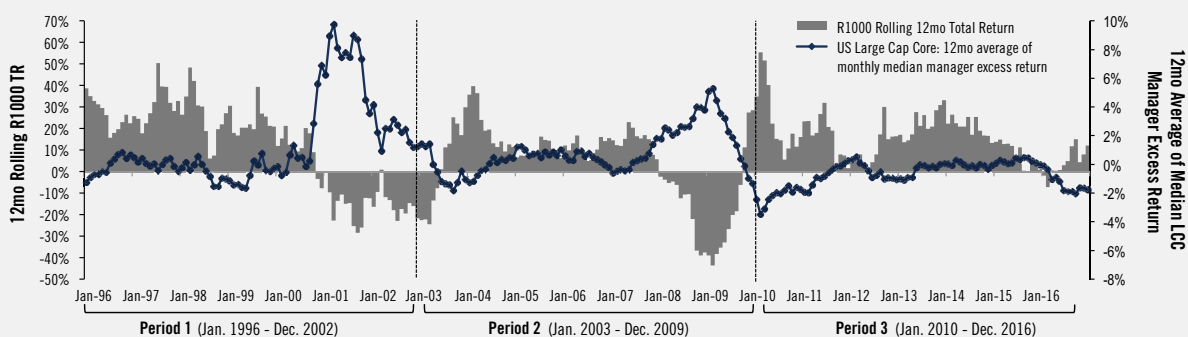
This investment case does not suggest blindly offering active management in all cases. It requires thoughtfully considering asset classes and strategies that have higher probabilities of success in producing alpha. However, just looking at single points in time to determine the efficacy of active management in different asset classes may not be enough as history has shown that active performance is cyclical in nature. For example, when analyzing performance of the eVestment universe of US Large Cap Core active equity managers, an asset class often labeled as highly efficient, we find that active returns are related to market

conditions such as volatility, dispersion, and overall market performance (Figure 2).³ In periods where market volatility and stock dispersion were elevated, active managers tended to perform better against the index. Additionally, active managers tended to outperform most in periods of market downturns. The persistence of this trend going forward can directly benefit DC participants who tend to react negatively to poor markets and who are particularly susceptible to sequence of return risk around the years of retirement.

Success in active management is certainly not guaranteed, but the institutional approach uses methods to increase the probability of success by using a thoughtful mix of active and passive, using scale to drive down costs, relying on experts to help select strategies, and diversifying amongst approaches. Consolidating choice among investment options that allocate across multiple strategy types, often referred to as multi-manager portfolios, is one way to effectively do this. For those not interested in building multi-manager options within the plan, staying committed to offering broadly diversified active and passive investment choice both on the core menu and in the default solution is important and can have a significant impact on retirement outcomes. There is a reason institutional investors employ such strategies and there is a strong investment case to bring these methods to defined contribution participants, relative to an approach that optimizes on maximizing investment simplicity and minimizing fees.

Figure 2: Active Equity Manager Results are Counter-Cyclical

Rolling 1-Year Active Manager Median Excess Return vs. Market Return



Source: PGIM IAS, Datastream, eVestment. Performance gross of fees as reported by eVestment. Past performance is not a guarantee or a reliable indicator of future results. Chart is provided for illustrative purposes only and is not indicative of past or future performance of any PGIM product.



THE FIDUCIARY CASE

One of the biggest drivers of the trend toward the simple approach in DC plans has been perceived litigation risk by plan sponsors. Ironically, one could argue that the trend of moving towards simple and cheap investment menus actually creates more legal risk by putting the sponsors' interests ahead of the participants' interests.

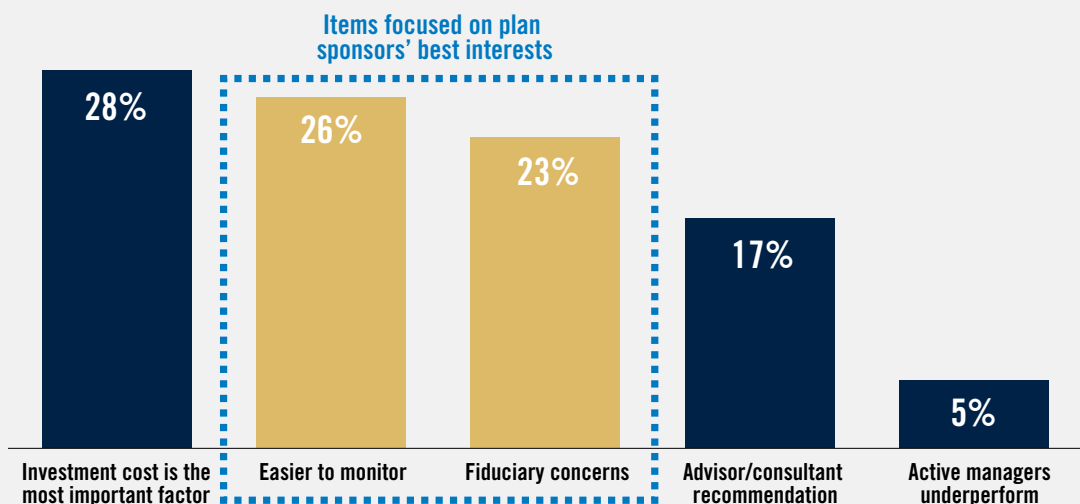
According to ERISA, the Duty of Loyalty requires plan sponsors to act in the best interest of participants. But are sponsors that choose the simple approach really doing so solely for the benefit of participants? When surveyed, it was found that sponsors often go passive to alleviate the threat of litigation and not because of performance, clearly acting in their own best interests (Figure 3).⁴ While fees are critical, ERISA only requires that they be “reasonable,” and not necessarily lowest. Plan sponsors should first determine what is best for the plan and its beneficiaries, and then analyze cost in a broader context of overall value.

One need not look further than recent court rulings on excessive fee lawsuits to be reminded of this. Such cases included language that the defendant could not be held liable for “failing to choose the cheapest fund.”⁵ Other examples include a rejection of a plaintiff’s assertion that “fiduciaries must maintain a myopic focus on the singular goal of lower fees”⁶ and that “unquestionably, fiduciaries need not choose the cheapest fees available to the exclusion of other considerations.”⁷ In 2017, the judge hearing a case brought against Putnam Investments cited precedent finding “nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund,”⁸ which was established almost 10 years ago in one of the first excessive fee cases in the industry.⁹

Survey data has also shown that plan sponsors select passive investments because they are easier to monitor (Figure 3). However, ERISA’s Duty of Prudence requires fiduciaries to follow a prudent process when making (and monitoring) investment and administrative decisions for the plan. This includes a fair evaluation of the universe of investment asset classes and strategies. For plan sponsors not equipped to do so, fiduciary duty requires retaining experts to either aid in or fully assume these functions. And lest sponsors think that if they have passive funds they won’t get sued, there have been several lawsuits filed against those with passive funds, most recently including Home Depot.¹⁰ In the complaint filed in April 2018, the plaintiff alleged the plan imprudently retained a passively managed target-date fund suite when five better performing peers (including three active/passive hybrid strategies) were available. Such an argument is likely to face difficulty in court, just as a suit that makes the same backward-looking claims against an investment option that is highly active. ERISA is designed to protect sponsors from such specific performance comparisons, but it is emblematic of the fact that no one is immune from the threat of lawsuits, regardless of the type of plan you have decided to implement.

As a reminder, it is not just plan sponsors who are at risk of participant litigation. Insurance companies who issue fiduciary

Figure 3: Reasons Plan Sponsors Go Passive



Source: Cerulli Associates: US Retirement Markets 2017; Large Plan Sponsors

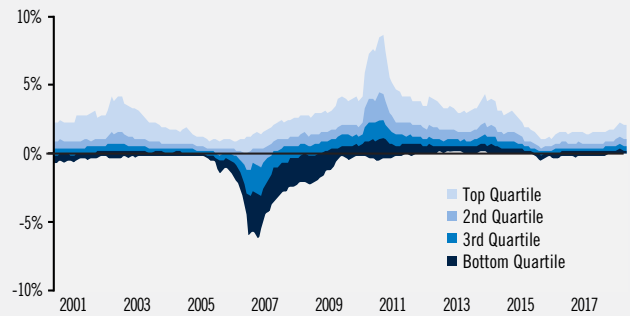
liability policies to plan sponsors are also liable. When asked in an interview about underwriting plan sponsors, Rhonda Prussack of Berkshire Hathaway focused on the importance of a prudent decision-making process and analyzing value. “The best way to demonstrate they’re a good fiduciary risk is to have robust fiduciary processes in place. If you have a plan committee, demonstrate that the members understand their responsibilities, that they document their discussion at meetings, especially when selecting and monitoring investments and fees charged to the plan,” stated Prussack. She also went on to highlight the importance of periodically assessing the value received in relation to fees.¹¹

So, how does a sponsor determine what is a prudent investment that is in the best interest of their participants? One thing they can do is look to the portfolios of their institutional peers. For example, very few institutional investors invest passively in fixed income given structural issues with benchmarks and the ability of active managers to add value historically (Figure 4). Active managers have significantly outperformed relative to traditional bond indices, most notably in providing downside protection from rising interest rates (Figure 5).

Additionally, fixed income is often used to hedge financial liabilities which is increasingly becoming of interest to DC plans for managing income in retirement. However, naively implementing market-based benchmarks to meet a complex liability stream can entail significant risk due to mismatched duration or cash flow profiles. Active management can be much more beneficial when investing to solve for specific outcomes, providing a more flexible and precise approach.

“Very few institutional investors invest passively in fixed income given structural issues with benchmarks and the ability of active managers to add value historically.”

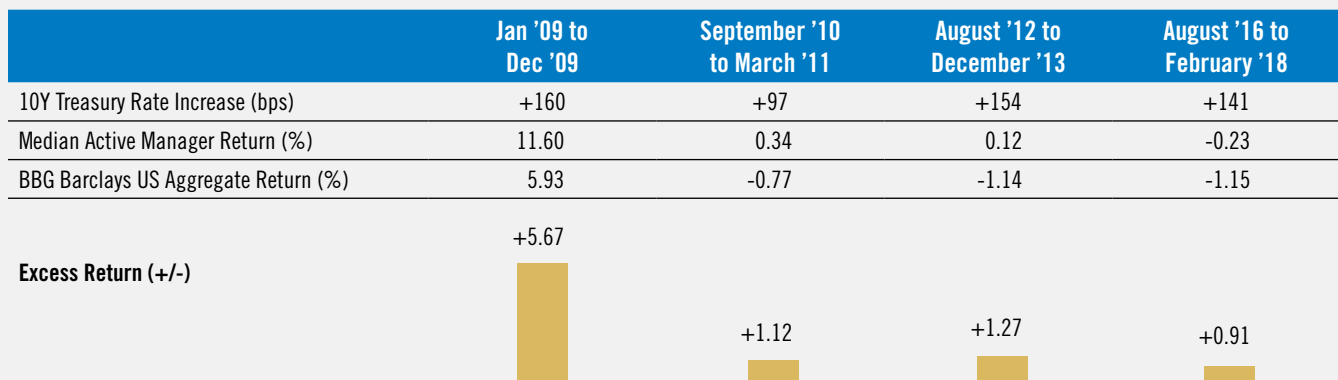
Figure 4: Majority of Active Fixed Income Managers Outperform the Benchmark
Rolling 3-Year Active Manager Excess Return



Source: eVestment as of 3/31/2018. Past performance is not a guarantee or a reliable indicator of future results. Performance gross of fees as reported by eVestment. Rolling 3-year annualized returns, over a 20-year period. Peer group composed of eVestment US Core Bond & US Core Plus Bond active manager universes. Bloomberg Barclays US Aggregate Index used as benchmark. Chart is provided for illustrative purposes only and is not indicative of past or future performance of any PGIM product.

When evaluating investments, whether single asset classes or target date funds, plan sponsors who focus on cost over value to reduce perceived fiduciary risk are likely to end up with less-effective solutions. The fiduciary case for an institutional approach focuses on the obligation to offer to participants options that the sponsor believes will result in the best outcome for participants. It is improbable that a solution focused on minimizing absolute level of fees is also one that offers the highest probability of success, and thus would not be a solution that is in the participants’ best interest.

Figure 5: Active Fixed Income Managers Have Been Able to Add Alpha When Interest Rates Rise



Source: eVestment. Past performance is not a guarantee or a reliable indicator of future results. Performance gross of fees as reported by eVestment. Peer group composed of eVestment US Core Bond & US Core Plus Bond active manager universes. Chart is provided for illustrative purposes only and is not indicative of past or future performance of any PGIM product.



THE WELLNESS CASE

Even if there is an investment case for an institutional approach, why should sponsors make the effort to do so? The benefits of institutional investment design in DC plans can also have a meaningful impact on participant financial wellness, a growing focus for plan sponsors today. Employers are beginning to see the advantages of a workforce that is less financially stressed and more retirement ready.

Research indicates that 57% of employees are very or somewhat stressed about their financial situation (the biggest contributor of which is ‘saving for the future’),¹² ultimately leading to significant distractions at work. Studies have also shown that average 401(k) participant savings rates, when combined with employer contributions, fall at the low end^{13,14} of the recommended 11%-16% range¹⁵ and that one in four employees fail to save enough to receive their full employer match.¹⁶

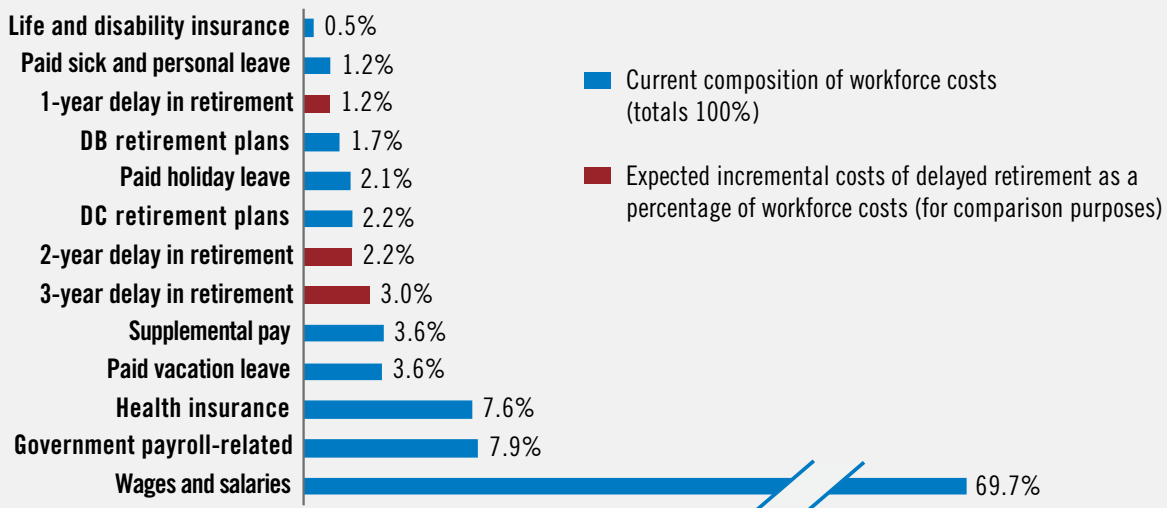
“When surveyed, 57% of finance executives think that a significant portion of their employees will have to postpone retirement due to inadequate retirement savings.”

Given these statistics, it is not surprising that more emphasis is being put on the “benefits” of working beyond age 65 (18.8% of workers today, up from 12.8% in 2000¹⁷). Record keepers often offer basic retirement income projection tools that can highlight the advantage of extending one’s retirement age, along with other related factors. While working longer may have a beneficial impact on participants’ retirement savings, it comes at a great, often unknown, expense to employers.

A Prudential Financial, Inc. (PFI) research study recently estimated that for a typical company there can be an incremental cost to employers of \$50,000 for each year a worker delays retirement.¹⁸ On a company-wide basis, a one-year delay is estimated to be 1.0%-1.5% of all annual workforce costs, roughly equal to the cost of paid sick and personal leave and twice the expense of life and disability insurance (Figure 6). Although employers may not truly understand the costs of delays in

Figure 6: Cost of Delayed Retirements to Employers

Composition of Private Sector Workforce Costs

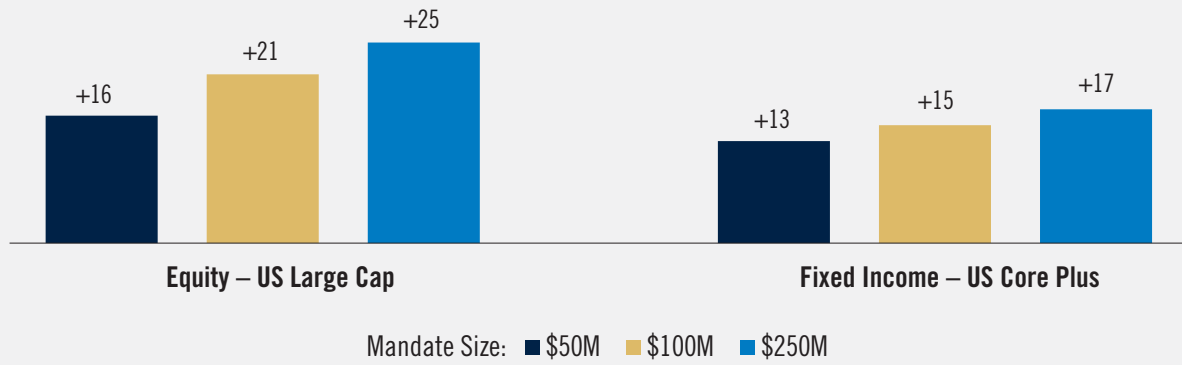


Notes:

- 1. DB retirement plans include premiums, administration fees, and dollar amounts placed by employers into pension funds.
- 2. Supplemental pay includes overtime, shift differentials, and nonproduction bonuses.
- 3. Government payroll-related includes Social Security, Medicare, Federal and State Unemployment Insurance and Worker’s Comp.

Source: Bureau of Labor Statistics, Employer Costs for Employee Compensation – March 2016, Table 5, June 2016. PFI analysis with supporting research by Goldenson Center at University of Connecticut.

Figure 7: Fee Break Moving from Institutional Mutual Funds to Commingled Funds (in bps)



Source: eVestment as of 3/31/18. An additional fee of 5 basis points (0.05%) was added to commingled vehicle-published management fees for operational expenses.

employee retirement, they do believe the delays will occur. When surveyed, 57% of finance executives think that a significant portion of their employees will have to postpone retirement due to inadequate retirement savings.¹⁹

Obvious ways to improve employee financial health and reduce delays of retirement include utilizing more holistic financial wellness programs and increasing DC savings default and employer matching rates. However, while they are all important, each has explicit costs. An additional approach DC plan sponsors can take is through institutional investment menu design. As discussed, this includes offering broadly diversified options with a thoughtful mix of active and passive management, providing the potential for alpha and greater protection in negative market

events. Institutional options should also be vehicle agnostic and, most importantly, competitively priced. Results from these two actions alone can be significant as we saw previously the case for an additional 0.35% a year in performance. In fact, many plans that offer actively managed strategies can experience significant fee savings just by considering commingled vehicles. An analysis of fee data in eVestment shows that moving to a commingled fund can save over 16 basis points (0.16%) in US large cap equity mandates and 13 basis points (0.13%) in US core plus bond mandates (Figure 7).

Awareness of a workforce’s retirement readiness is extremely important for employers, not just in enhancing the experience of employees at work but also in running a business. While plan design and employee education are key levers to pull, an institutional investment approach is needed to help participants better invest for the retirement liabilities they have been asked to manage. Neither a retail approach focused on lots of choice and name brand funds, nor an approach focused on simplicity, is aligned with meeting these retirement readiness objectives.

“ An institutional investment approach is needed to help participants better invest for the retirement liabilities they have been asked to manage. ”



THE FAIRNESS CASE

There is a notion by those who support the simple approach that because most participants are novice investors, they should not have exposure to more “sophisticated” investments that other institutional investors often use. But is that fair? If these are good investment options, should participants be denied such access?

To the extent it is operationally feasible, DC sponsors should look to portfolios of their institutional counterparts as guidance when designing investment options. While objectives of these investor types differ, and so should their investment solutions, it is the institutional approach taken by these investors that can improve the success of defined contribution plans. And, it should be noted, a need for simple-to-use solutions like target date funds does not necessarily mean the investments underneath must be simple.

The types of investments that are often attractive to other institutional investors include extended credit sectors such as high yield and emerging markets, alternatives such as hedge funds, and private assets such as real estate, private equity, and infrastructure. It also applies equally to outcome-based solutions like retirement income and capital preservation, as well as services such as professionally managed accounts.

As an example of an institutional approach, alternative asset classes such as private real estate have been a strategic allocation of institutional portfolios historically. In Preqin’s most recent Alternative Assets Investor Outlook which surveyed over 550 institutional investors, 70% of respondents reported a target allocation to private real estate ranging from 5%-15%.²⁰ But it is not just institutional investors that want exposure to the asset class. Individuals also rely on investments in property to build and grow their wealth, highlighting the importance of consideration for inclusion on DC menus. According to National Real Estate Investor, 62% of high net worth (HNW) individuals hold average allocations to real estate of 5-25%.²¹ Typical American workers are not accredited investors and thus cannot access many of these strategies on their own, but it can be done within a DC plan. Even for those that can get access in personal portfolios, pricing is likely to be significantly higher than the typical range of 0.7%-1.0% for DC-specific strategies. Should participants really be denied access to this highly sought-after asset class just because of preferences to offer solutions that are simple and cheap?

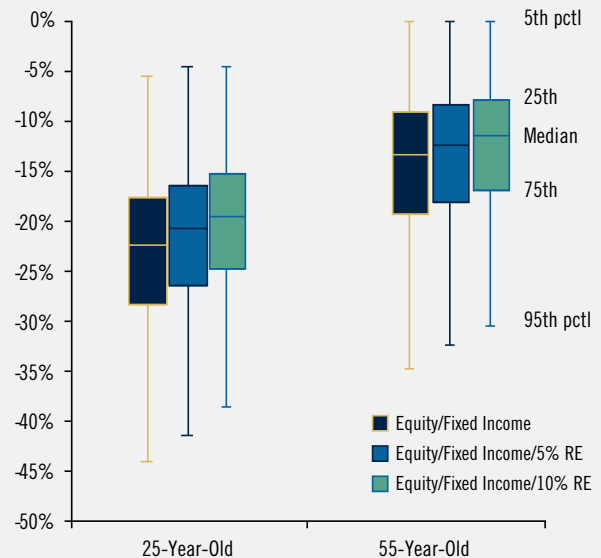
Plan sponsors may be surprised to hear that private real estate has been accessible to DC plans in daily-valued commingled vehicles for over a decade, and the inclusion in DC plans is growing.²² Operational concerns are often cited as reasons for not offering such strategies; however, these challenges have largely been solved for using a combination of open-ended underlying vehicle structures, fund-level liquidity sleeves, and limiting inclusion to sleeves within multi-asset mandates, like target date funds.

Why is this considered such an attractive asset class? Most institutional investors, at a high level, understand the value of private real estate through traditional modern portfolio theory (MPT) statistics like standard deviation and Sharpe ratio. However, measuring the impact on outcomes may be more meaningful to sponsors.

In doing so, we conducted a stochastic analysis of portfolios for theoretical DC retirement savers using domestic equities, fixed income, and private real estate. Portfolio asset allocation mixes were similar to that of a target-date glide path that de-risks over time based on age. Our research shows that over longer horizons (such as all or part of an employee’s working career), a modest allocation to real estate results in a meaningful reduction in both

Figure 8: Private Real Estate Improves Portfolio Drawdowns

Accumulation Phase Projected Maximum Drawdowns by Age and Real Estate Exposure



See Endnote 23 for additional information. Projections done for 2 age cohorts up to age 65 using 5,000 trials. Asset allocation modeled similar to a target-date glide path based on age. Exposure to private real estate held static over glide path and taken from equity exposure. Maximum drawdown is the largest portfolio loss measured from peak to trough. Hypothetical example for illustrative purposes only.

the magnitude and range of projected portfolio drawdowns (Figure 8), particularly in more adverse scenarios.²³ Given investor aversion to losses, particularly for near-retirees who are highly exposed to sequence of return risk, downside protection could be significantly beneficial to participant outcomes. Additionally, a smoother path in performance not only benefits participants who are more likely to stay invested, but also DC plan sponsors and their committees in staying committed to their investment selections.

Sophisticated investors of all kinds understand the benefits of unique investment strategies to grow wealth and manage key risks. Given that plan sponsors and consultants have the ability to bring this approach to the typical participant, at institutional pricing, there is a compelling case that it is only fair that they try and do so.

THE VERDICT

Upon deliberations on the appropriate investment approach for a Defined Contribution plan, we find that an institutional approach is superior to all others. There is not one way to implement an institutional approach. However, there is a strong case for making decisions the way other institutionally minded investors approach the problem of trying to meet an objective. The retail approach is guilty of focusing on what we think participants want instead of what, as fiduciaries, we believe they need. The simple approach is guilty of making the primary driver of any decision the desire to minimize total cost, instead of striving for better outcomes. The evidence supports an institutional approach based on:

- **The Investment Case:** Enhancing risk-adjusted performance
- **The Fiduciary Case:** Putting the interests of participants first
- **The Wellness Case:** Improving retirement readiness
- **The Fairness Case:** Bringing institutional solutions to individual participants

ENDNOTES

1. Cerulli Associates: US Retirement Markets 2017; Large Plan Sponsors
2. Participant assumptions: initial age of 23, initial salary of \$40,000 with 3% annual salary growth, 10% savings rate, and withdrawal rate of 71% of final salary with subsequent 3% annual cost-of-living adjustments beginning at age 66. Investment assumptions: annual portfolio return of 7%, passive investment fee of 0.10%, active investment fee of 0.60%, and 1.0% gross of fee alpha assumption with a tracking error of 3% normally distributed. Alpha percentiles net of fees: 0.03% at 25th percentile, 0.35% at 50th percentile, and 0.68% at 75th percentile.
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21. NREI, "HNWIs Continuing to Cash In on CRE," December 2017.
22. DCREC, "Survey of Real Estate Investment Managers," March 2016.
23. Stochastic analysis using Moody's Analytics Economic Scenario Generator compared two-asset portfolios of domestic equities and fixed income with three-asset portfolios of domestic equities, fixed income, and private real estate. Projections were done for 2 different age cohorts (25 & 55) up to an assumed retirement at age 65 using 5,000 trials. Portfolio asset allocation was modeled similar to a target-date glide path based on age. The base two-asset portfolio of domestic equities and fixed income was as follows: 85% (equities)/15% (fixed income) from age 25-35, 75%/25% from age 35-45, 65%/35% from age 45-55, and 55%/45% from age 55-65. Portfolios including private real estate held static allocations to the asset class over the glide path, coming from the existing equity allocation. Static allocations to real estate of 5% and 10% were used. Analysis is not meant for investment advice. Hypothetical example for illustrative purposes only.

	Return (%)	Risk (%)	Correlations		
			Equity	Fixed Income	Private RE
Equity	7.8	16.6	1.00	-	-
Fixed Income	5.0	6.3	0.37	1.00	-
Private RE	5.5	13.0	0.37	0.26	1.00

	25-Year-Old			55-Year-Old		
	Median	75th Pctl	95th Pctl	Median	75th Pctl	95th Pctl
Equity/Fixed Income	-22.3%	-28.2%	-43.9%	-13.2%	-19.4%	-34.8%
Equity/Fixed Income/10% RE	-19.4%	-24.6%	-38.6%	-11.5%	-16.8%	-30.3%
Max Drawdown Reduction	2.9%	3.6%	5.3%	1.7%	2.6%	4.5%

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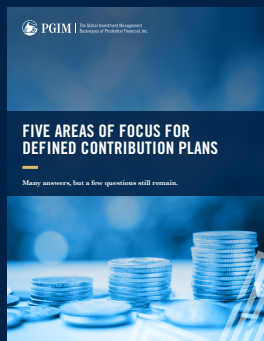
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