

Retirement Plan Investment Options

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Investment Options

Areas of Discussion

- Number of fund options and which ones
- Cost of the funds and Plan services
- QDIA/Target Date Funds
- Investment Policy



2013 “Hot Topics”

- Comprehensive review of fund offerings
- Change offerings to reduce costs
- Change funds from active to passive
- Consolidation of investment menus
- Additional asset classes for greater diversification
- **Focus on behavioral finance and participant plan usage**

Aon Hewitt – 2013 Hot Topics in Retirement; Snyder, Jeffrey – 8 Hot Topics for Retirement Plan Sponsors , 2013.



Assumptions

- 401(k) vs 403(b)
- Funds vs stocks, brokerage windows
- Performance is based on two factors:
 - Quality of investment options
 - Choices/allocations chosen by participants



Efficiency of Investment Options

- “Efficiency” –performance cannot be significantly increased by adding more investment choices to the Plan¹
- “The overwhelming majority of 401(k) menus” are efficient, based on a 2009 study of over 1,000 Vanguard Plans (with almost 1 million participants)²

¹ – Elton, Gruber and Blake, 2006. ² – Tang, Mitchell, Mottola & Utkus, 2009.



Real-World Fallacy

- Knowledgeable investors could construct a mean-variance efficient portfolio with the available fund options
- Actual participants fall short; estimates are that retirement wealth over a 35-year worklife could be reduced by one-fifth due to participant diversification errors¹

¹ - Tang, Mitchell, Mottola & Utkus, 2009.



Real World Fallacy

- If an expected diversified portfolio would generate an annual real return of 5%, the typical participant would be predicted to forfeit 23% of his wealth due to his errors.
- On average, 24% of that loss is due to plan menu options, 76% is due to participant investment mistakes

Source -Tang, Mitchell, Mottola & Utkus, 2009.



15 years of Behavioral Finance

- **Choice paralysis** – negative correlation between number of funds and participation rate
- 5% drop in participation in a plan with 5 funds vs 15; over 30 funds – 4% drop for every additional 5 funds
- With more choices, participants gravitate toward money markets, away from stocks

Source - Iyengar, Jiang & Huberman, 2003.



15 years of Behavioral Finance

- **Naïve Diversification** = “1 / n” heuristic
 - Especially if there are <10 options
- **Status Quo Bias**
 - Median # of allocation changes over participants’ lifetimes was zero¹
 - More than half had the same allocation at retirement as when they initially enrolled²

¹ -Samuelson & Zeckhauser, 1988, ²- Ameriks & Zeldes, 2000.



Fidelity Magellan: 1977–1990



- Beat the S&P 500 benchmark in 11 of those 13 years
- Annual average return of 29%.



When Peter Lynch left Magellan (1990)

- Margaret Thatcher resigns as British PM
- East and West Germany reunite
- Tim Berners-Lee wrote the first web page for the World Wide Web
- "The Simpsons " is aired for the first time
- Popular Films: Ghost, Pretty Woman and Teenage Mutant Ninja Turtles



Magellan recent performance

▶ Fidelity Magellan			Ticker: FMAGX	Fund Category: LG	
Total Return - 1 year Top 50%	35%		Total Return - 3 year Top 50%	97%	▶
Std. Deviation - 5 year Lowest 50%	94%	▶	Alpha Top 50%	94%	▶
Product History 3 or more years	49 yrs.		Manager Tenure 2 or more years	1 yrs.	5

This fund has  1 news item

Total Return - 5 year Top 50%	96%	▶	Std. Deviation - 3 year Lowest 50%	72%	▶
R-squared 80% or greater	96%		Sharpe Ratio Top 50%	79%	▶
Expense Ratio Lowest 50%	13%		Asset Value in Product \$75 Million or more	\$15,126M	

1% is the best, 100% is the worst



Real Life Scenario – July 2013

- 403(b) Plan added Fidelity as an option in mid-1980's
- Core options cut from 162 to 14
- 54% of participants only held 1 or 2 funds.
- 23% of participants held Magellan



August 2013 – Schwab Survey

- More than half (52%) find explanations of their 401(k) investments more confusing than explanations of their health care benefits (48%).
- Nearly half (46%) don't feel they know what their best investment options are and one-third (34%) feel a lot of stress over correctly allocating their 401(k) dollars.
- Fifty-seven percent wish there was an easier way to figure out how to choose the right 401(k) investments.



The Question

How do we help maximize the participants' experience and outcomes?



The Answer

Simplify the decision making to reduce stress



The More Specific Answer:

Restructure the Menu

Have the participant focus on a choice they can comfortably make



What we see now

ALLOCATION OF INVESTMENTS (use whole percentages only):

Stability of Principal			Growth Continued		
	%	Guaranteed		%	SA23 Large Capitalization Equity
	%	SA14 Short Term		%	SA66 MFS VIT Capital Opportunities Series
Income				%	SA67 MFS VIT Utilities Series
	%	SA12 Government/Corporate Bond		%	SA38 Neuberger Berman AMT Regency
	%	SA20 High Yield Bond		%	SA33 Social Awareness
	%	SA78 SSR Government Income		%	SA62 Templeton Growth Securities
Growth & Income				%	SA79 SSR Investment Trust
	%	SA49 AFIS Growth-Income		%	SA81 SSR Legacy
	%	SA32 Aggressive Balanced		%	SA83 SSR Mid-Cap Value
	%	SA19 Alliance VPS Growth and Income	Aggressive Growth		
	%	SA21 Balanced		%	SA46 AFIS Global Small Capitalization
	%	SA30 Conservative Balanced		%	SA31 Alliance VPS Technology
	%	SA11 Core Equity			
	%	SA61 Delaware Growth and Income		%	SA56 Delaware VIP Small Cap Value Series
	%	SA27 Scudder VIT Equity 500 Index		%	SA36 Scudder VIT Small Cap Index
	%	SA57 Fidelity VIP Equity-Income		%	SA63 Franklin Small Cap
	%	SA55 Delaware VIP REIT Series		%	SA64 Janus Aspen Series Aggressive Growth
	%	SA28 Value Equity		%	SA17 Medium Capitalization Equity
	%	SA80 SSR Large-Cap Value		%	SA65 MFS VIT Emerging Growth Series
Growth				%	SA37 Neuberger Berman Mid-Cap Growth
	%	SA48 AFIS Growth		%	SA24 Small Capitalization Equity
	%	SA54 AFIS International		%	SA75 SSR Aurora
	%	SA39 Alliance VPS Alliance Bernstein Small Cap Value		%	SA76 SSR Emerging Growth
	%	SA29 Alliance VPS Premier Growth		%	SA77 SSR Global Resources
	%	SA40 Scudder VIT EAFE® Equity Index		%	SA82 SSR Mid-Cap Growth
	%	SA35 Fidelity VIP ContraFund®			
	%	SA58 Fidelity VIP Growth	100	%	Total (must equal 100)
	%	SA59 Fidelity VIP Overseas			



What we also see now...

401K Enrollment Form Sits At Bottom Of Desk Drawer For 22 Years

NEWS IN PHOTOS · Workplace · Economy · Human Interest · Coworkers
· Finance · Business · ISSUE 37·45 · Dec 12, 2001

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Camera Falls Out Of

Mother Still



New thoughts on structure

- “Tiers” or “categories” to encourage easier decision making
 - Do-it-for-me (50%) – QDIA
 - Do-it-myself (15%)
 - Somewhere in-between (35%)
- Target Date or Target Risk, a few core choices and a brokerage window?
- “Next Generation” customized QDIA options are on the horizon



Remember the focus:

The plan exists for the sole benefit of the participants and their beneficiaries

- Fiduciary requirement is for prudent process
- Genuine focus is to maximize participant outcomes



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DOL 408(b)-2 Fee Disclosure Requirements

- ❧ After July 1, 2012 each Retirement Plan Sponsor must obtain from each Party-In-Interest (anyone receiving compensation from retirement plan assets, including advisors, record keepers, auditors etc.) a disclosure of fees and services being rendered. It must also be disclosed whether or not a Party-In-Interest accepts fiduciary responsibility for the plan investments, in writing
- ❧ Each Plan Sponsor must know whether the disclosure is complete (You actually need a checklist)
- ❧ You will need to define, through comparative benchmarking, whether the fees that you are paying for the services that you are receiving are reasonable
- ❧ Failure to document the fees as reasonable creates a prohibited transaction under 408(b)(2) and must be disclosed to the DOL. Some vendors are distributing incomplete disclosures, which if not resolved, also creates a prohibited transaction

Common Non-conformities seen in Retirement Plans as they relate to investments:

- ❧ No Investment Policy Statement (IPS) – while not required by ERISA, court cases have found plan’s in a fiduciary breach for not having one
- ❧ No congruency between a plan’s IPS and its investment monitoring report
- ❧ Plan’s IPS does not contain a watch list time horizon for the elimination of investments that fail the investment measurement criteria or if a time horizon listed, investments remain in menu long after the time horizon passed
- ❧ IPS is not signed by current members of the Investment Committee
- ❧ No language or measurement standards for QDIA’s, Target Date Funds, or “safe” investments like Stable Value or Money Market Funds

Target Date Funds

- ❧ Ballooned in popularity after the Pension Protection Act of 2006
- ❧ 2007 QDIA Final Rule stated plan fiduciaries must go through a prudent process in determining the appropriate default investment for the plan.
- ❧ In stock market drop of 2008, the average 2010 fund lost 25% with dispersions ranging from -9% to -41%
- ❧ Congress held hearings in 2009 to determine why TDF's performed so poorly - they released bulletins in May 2010 and followed-up this year, February 2013, to educate participants and plan sponsors
- ❧ Glidepath - "to" vs. "through"

QDIA Framework: A wide variation in risk levels in 2015 funds alone

By charting the 2015 target-date fund universe in terms of risk levels and the percentage allocated to equities, it is possible to see critical differences between many "to" and "through" funds. Risk/equity exposure levels vary wildly between both "to" and "through" funds, reminding plan sponsors how important it is to understand the portfolio construction of whatever type of target-date fund they choose.



Source: Morningstar, AIG analysis. Data as of 12/31/2011. Chart maps 2015 target-date funds with a three-year track record on two factors: risk (as measured by annual standard deviation, 1/1/2009-8/31/2011) and percentage of equity.

Determining the Appropriate Target Date Fund for your Plan

- ❧ Go through a questionnaire process to determine average employee demographics
- ❧ Once Glidepath is determined from plan demographics, must go through documented prudent process to determine which fund family appropriate based on IPS language
- ❧ Regularly review TDF's as part of normal quarterly investment monitoring
- ❧ QDIA rules do not provide fiduciary relief for an imprudently selected TDF

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