Retirement Plan Investment Options

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Introduction[1]

- Number 1 job of a DC plan - **improve participants' retirement readiness**

- **65% of respondents know its important to select a diverse mix of investments**

- **Only 7% of respondents confident they could select a diverse mix**

- **47% of respondents were *not* confident that they would be able to retire** because they didn't start saving early

[1] 2012 SSgA Participant Survey

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Selecting Investment Options

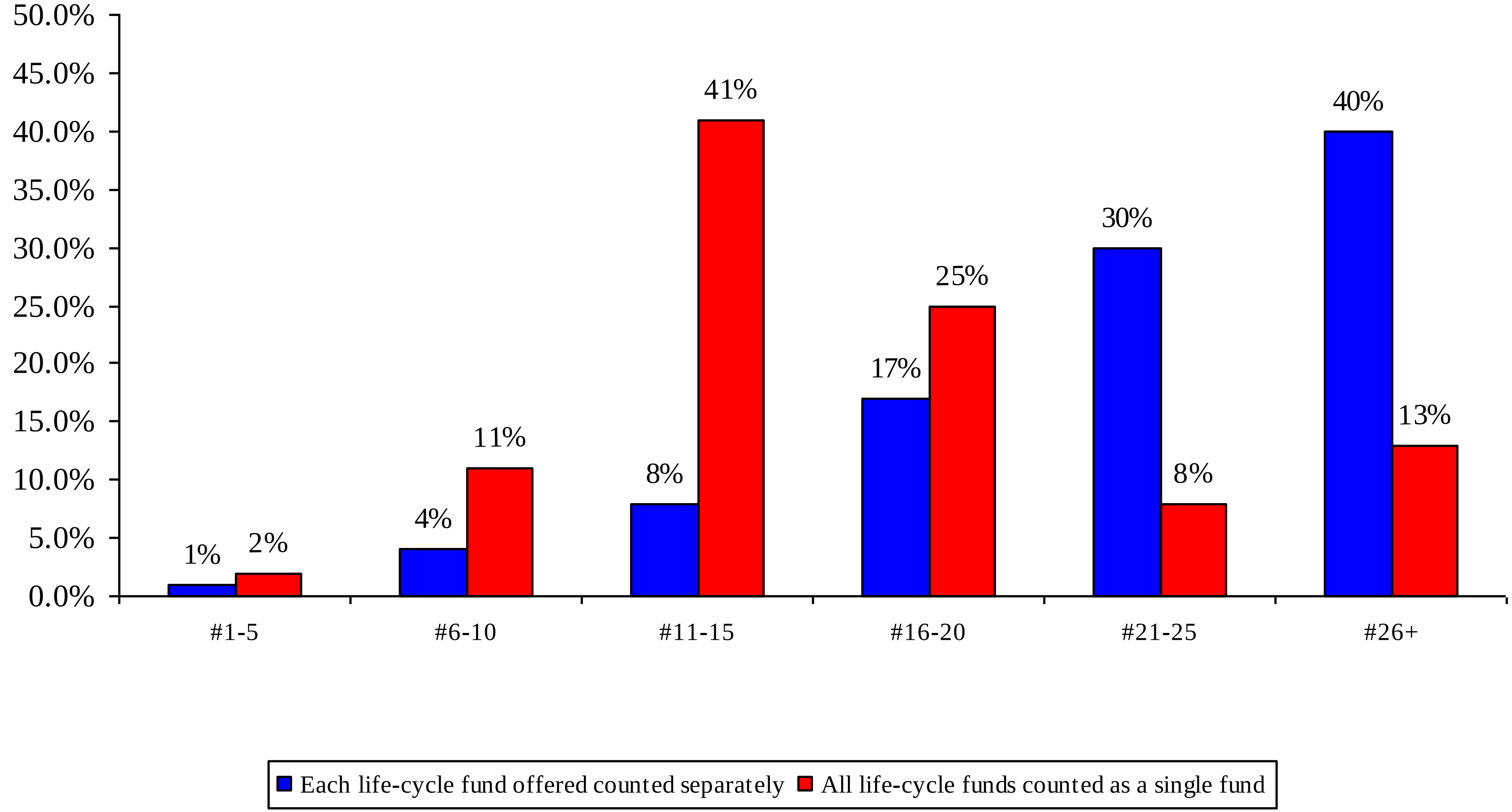
- Number of options isn't the only factor that affects participants' asset allocation decisions

- Participants make a less-than-optimal asset allocation if the strategies offered are concentrated within one asset class

- Participants' equity allocations tend to reflect the overall proportion of equity options within the plan
  - If equities make up 80% of investment options, the average participant's equity allocation is > 60%.
  - If the line-up is more balanced between equity and fixed income, the average equity allocation drops to 50%.[1]

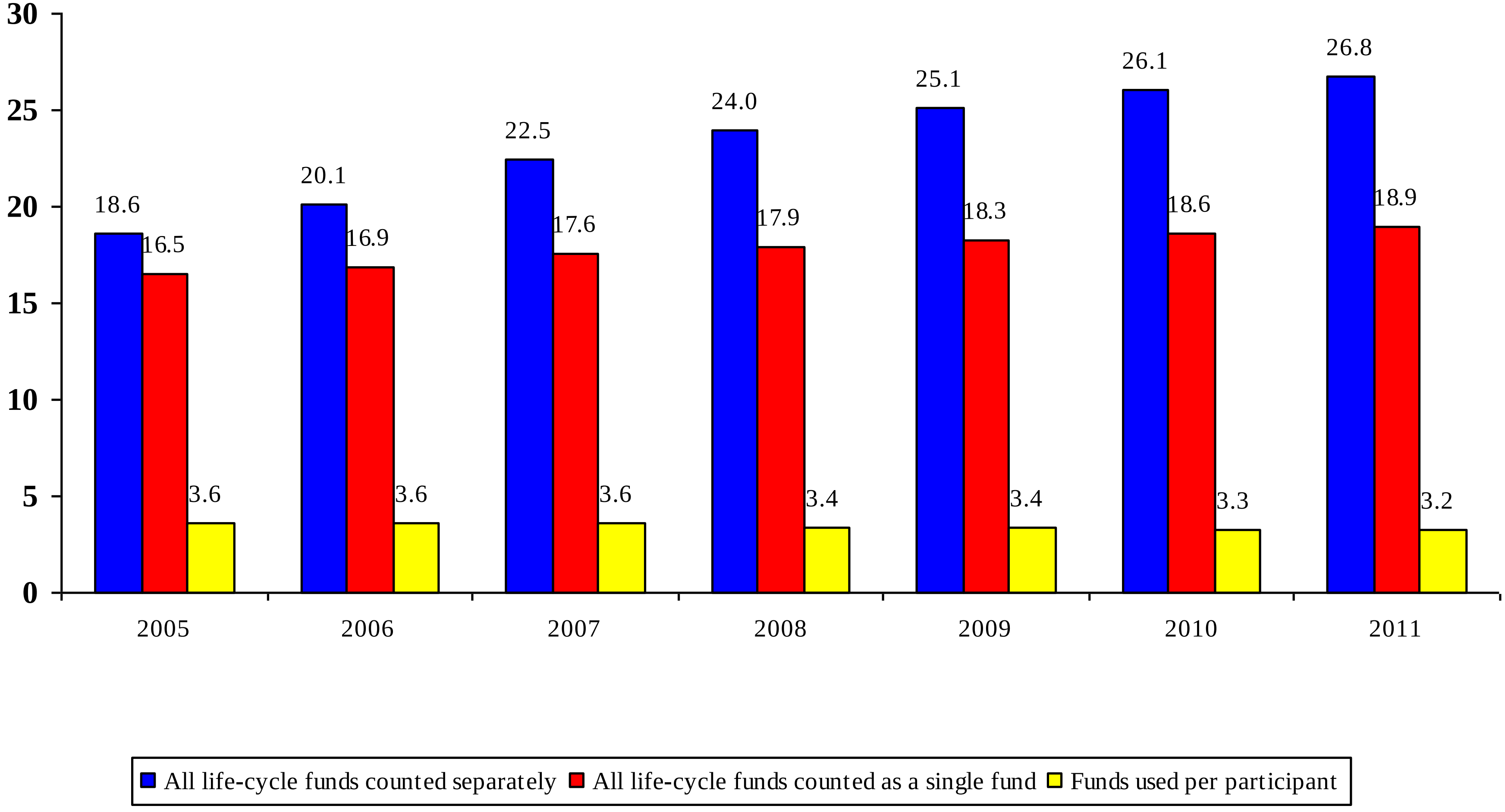
1 Benartzi, S. and R. Thaler. "Naïve Diversification Strategies in Defined Contribution Saving Plans." The American Economic Review, 2001

Number of Options Offered, 2011



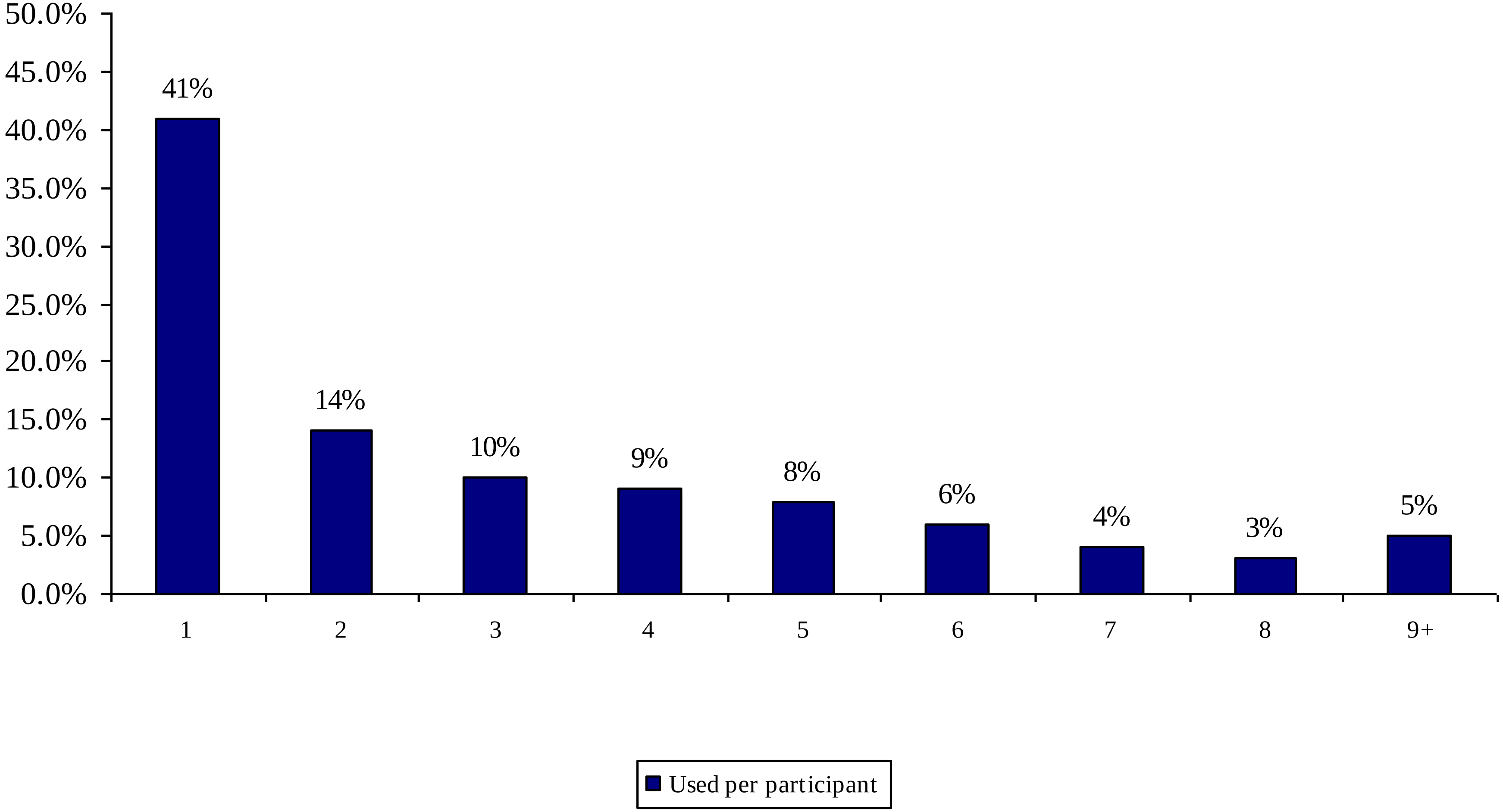
Source: Vanguard, "How America Saves," 2012.

Average Number of Investment Options



Source: Vanguard, "How America Saves," 2012.

Number of Options Used, 2011



Source: Vanguard, "How America Saves," 2012.

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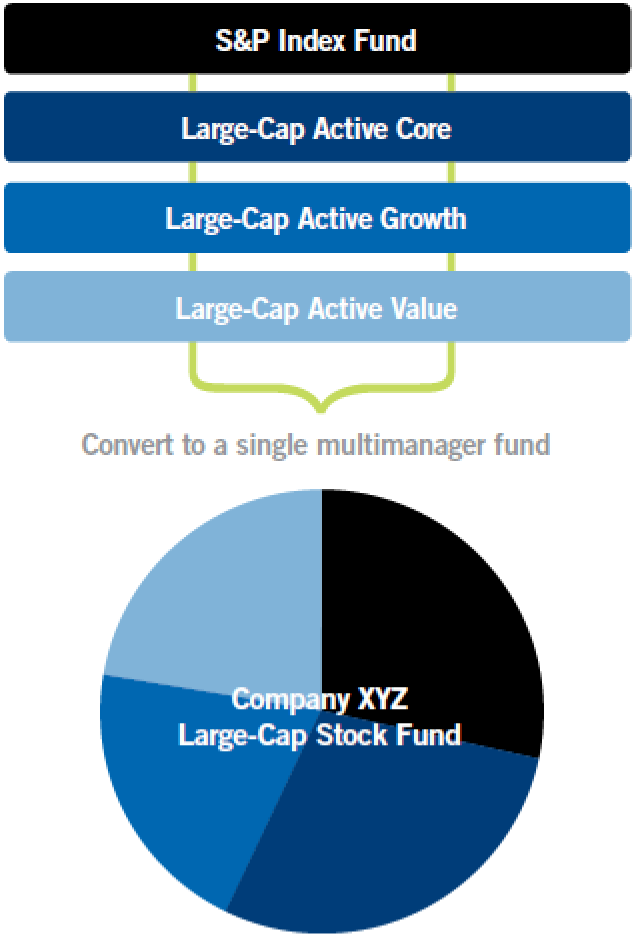
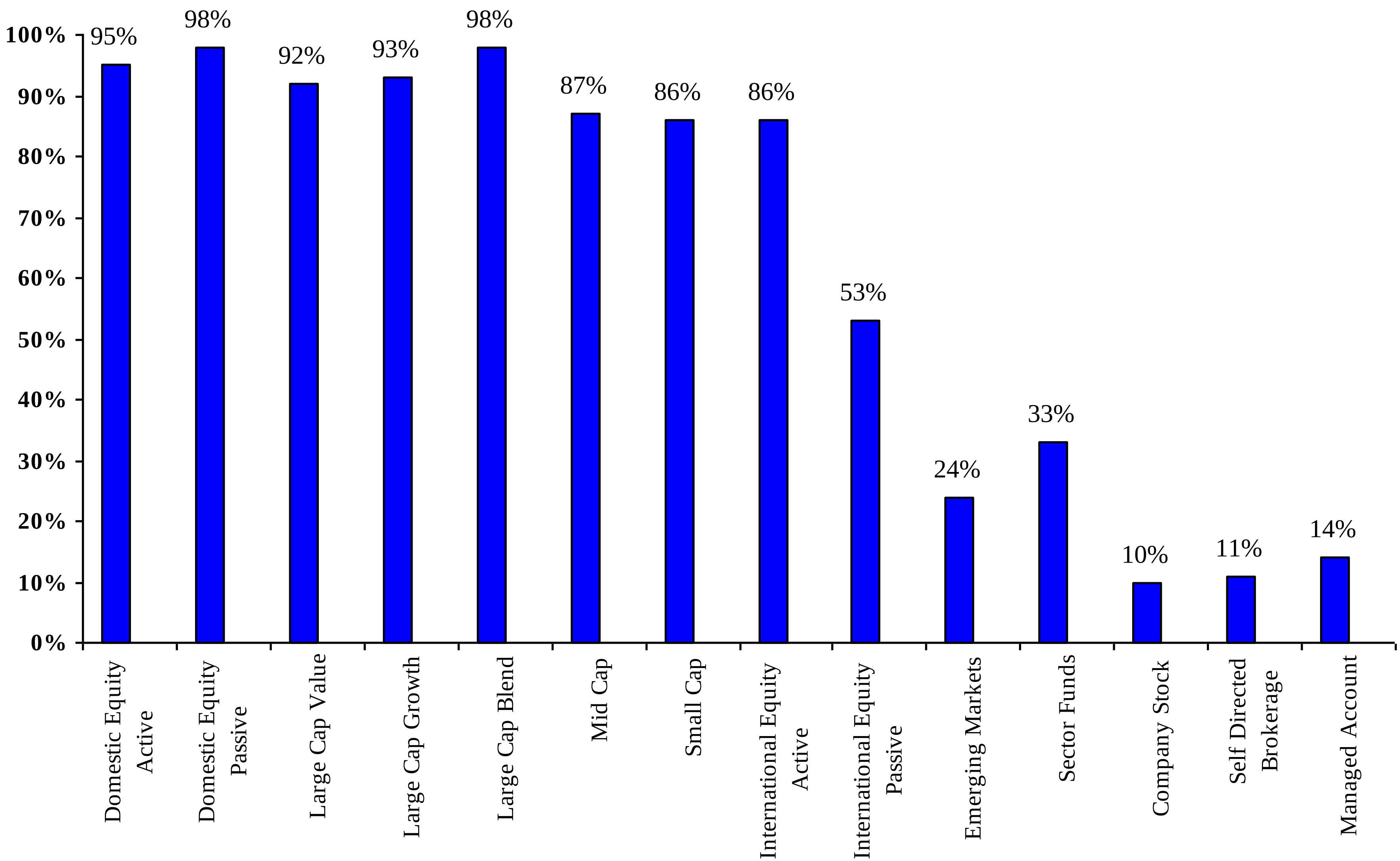
Using Multi-Manager/Fund of Funds Options

White Labeling – S&P Index, LCC, LCG, LCV - Large Cap Domestic Fund



Equity Investment Options Offered



Source: Vanguard, "How America Saves," 2012.

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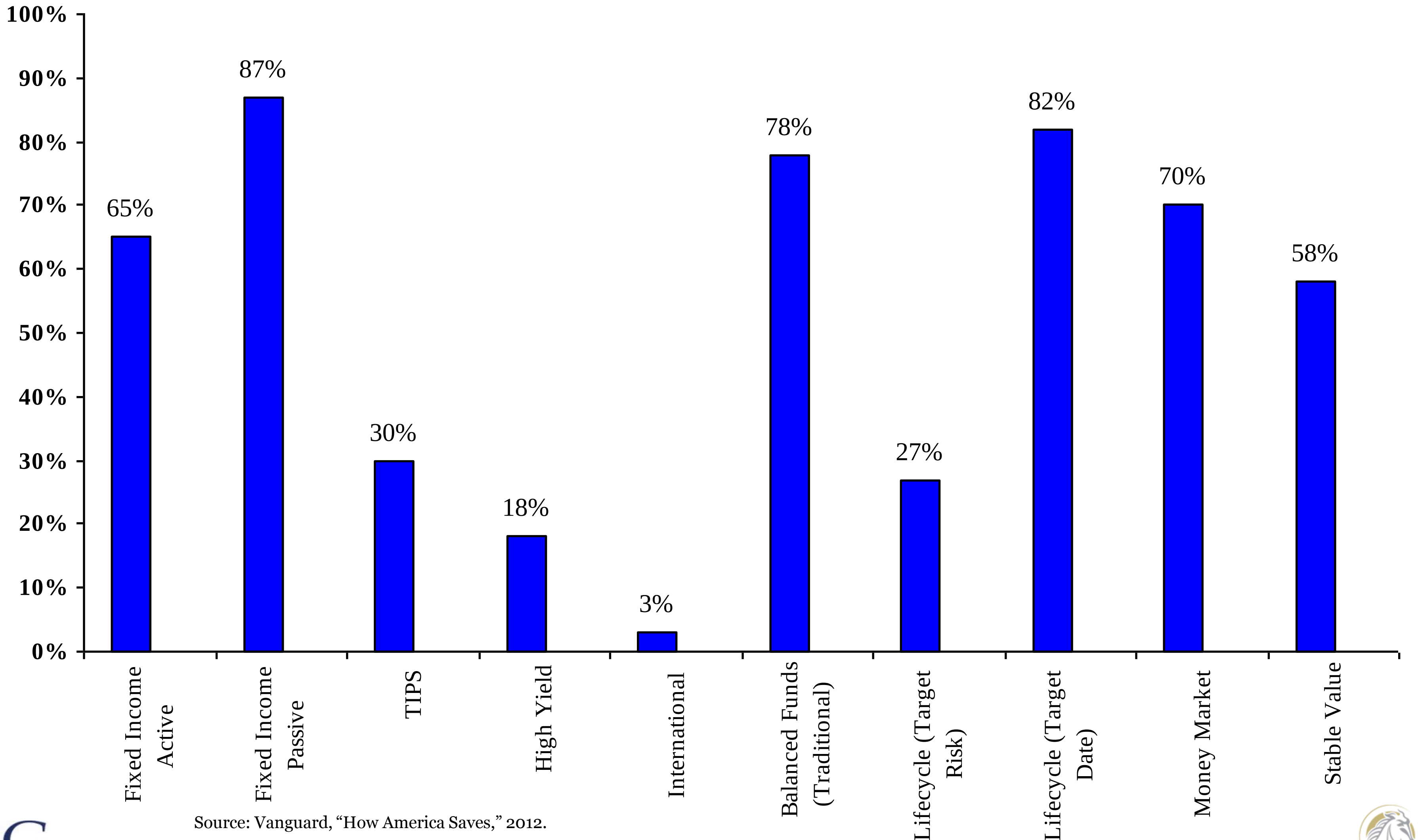
Fixed Income, Balanced & MM Investment Options Offered



Source: Vanguard, "How America Saves," 2012.

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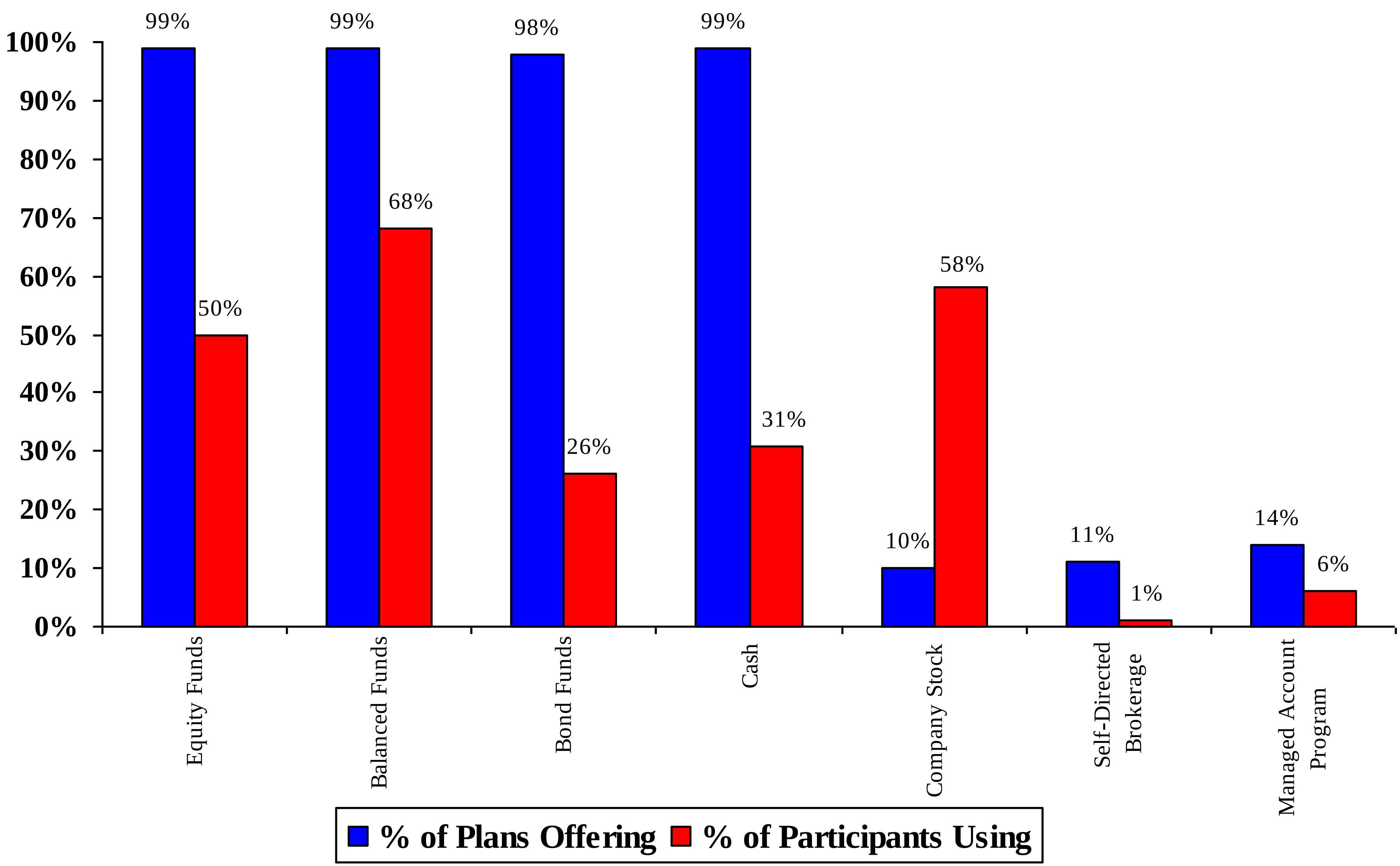
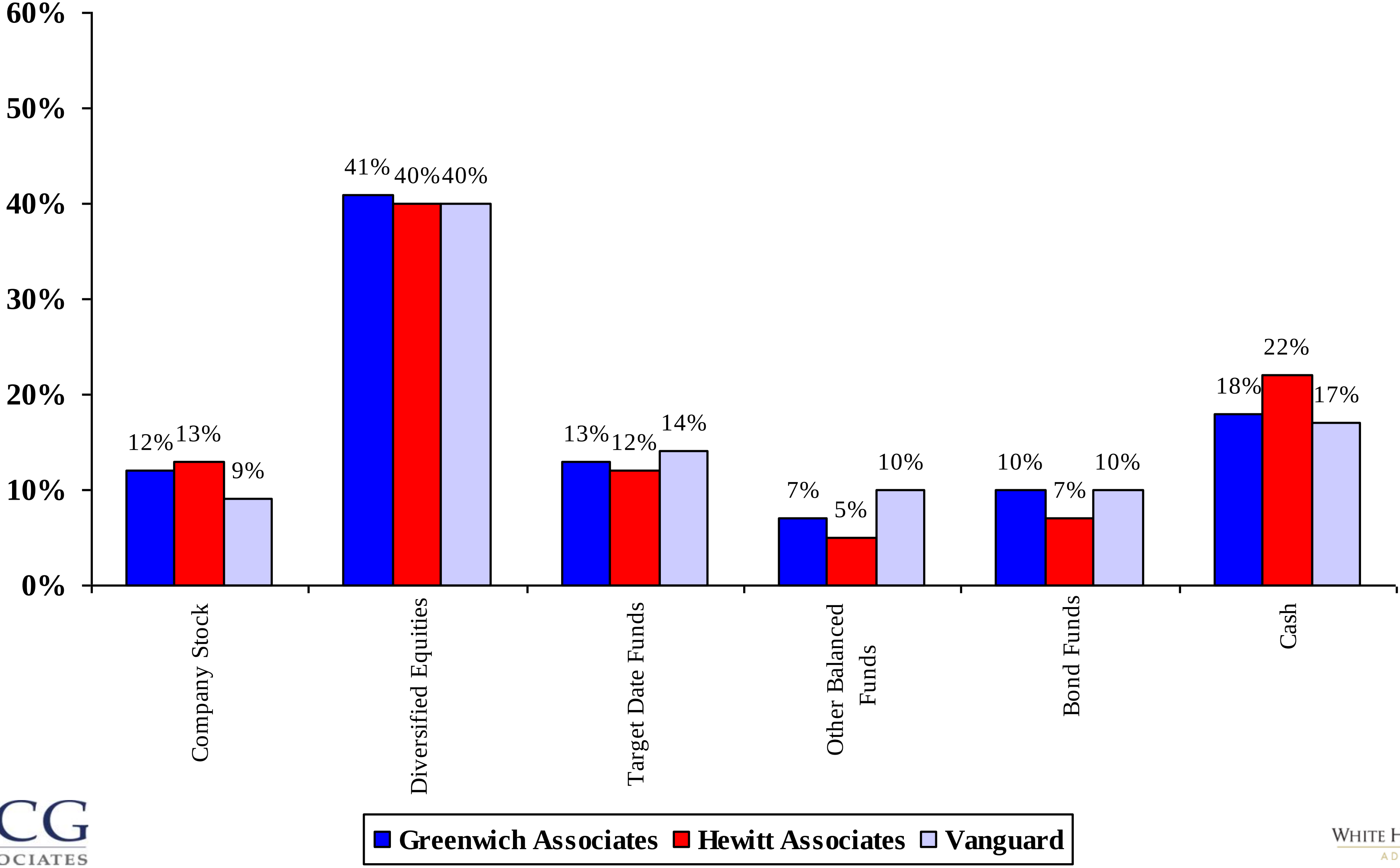
Participant Use of Asset Classes



Source: Vanguard, "How America Saves," 2012.

Plan Asset Allocation Summary



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Active vs. Passive Investment Options

Presence of Index Core Options

- **Growing focus on plan fees**

- Increased interest in **offering wider range of low-cost index funds** (aka passive)

- **44% of Vanguard plans offered a set of options providing an index core** in 2011

- Because large plans have adopted this approach more quickly, slightly more than half of all Vanguard participants were offered an index core as part of the overall plan investment menu

Active vs. Passive Management – Defined

Active Management

- Active management is simply an attempt to "beat" the market as measured by a particular benchmark or index. The S&P 500 Index is an example of an index that gauges the performance of the large-cap U.S. stock market – the so-called "blue chip" stocks.
- Prevailing market trends, the economy, political and other current events and company-specific factors (such as earnings growth and valuation) all affect an active manager's decisions. The aim of active fund management – after fees are paid – is to outperform the index for a particular fund (not to mention other fund managers they may be competing against).
- Many active managers do believe there are certain irregularities in the market that can be taken into consideration to achieve potentially higher returns.

Passive Management

- Passive management is more commonly called indexing. Indexing is an investment management approach based on investing in exactly the same company securities, in the same proportions, as an index. The management style is considered passive because portfolio managers don't make decisions about which securities to buy and sell; they simply copy the index by purchasing the same securities included in a particular stock or bond market index.
- Passive managers generally believe that it is difficult to beat the market. Therefore, they essentially offer asset class performance that closely matches an index for those investors who are unwilling to assume the risks of active management.

Passive Management

Top Reasons to be Passive

- ***Market-like returns*** – Indexing reduces volatility around the benchmark.
- ***Style consistency*** – Indexing closely tracks the characteristics of the benchmark.
- ***Lower expenses***.
- ***Tax-advantaged*** – Index strategies minimize portfolio turnover and capital gain distributions to investors.
- ***Efficient investment process*** – No need for manager search, selection and monitoring.

Issues for Consideration

- ***No possibility of excess returns (Alpha)*** – Investors should target index return less fees.
- ***Lack of control*** – Index managers are usually prohibited from using defensive measures if the manager thinks stock prices are going to decline.
- ***Index construction methodology*** – Most indexes are market-capitalization weighted (larger companies have higher weightings) to reflect the dollars invested in the market. They are not forward looking in terms of company prospects or valuation. Investors might be more concentrated in certain securities/sectors than they know. The Russell 1000 Value currently has 25% in Financials and was in fact almost 35% of the index in June 2007 going into the market downturn.
- ***Index replication*** – depending on the asset class it may be difficult to fully replicate the index. This is particularly true within fixed income and alternative asset classes.

Active Management

Top Reasons for Active Management

- ***Possibility of higher-than-index returns (Alpha)*** – Managers aim to beat the index.
- ***Expert analysis*** – Managers make decisions based on experience, judgment and market trends.
- ***Defensive measures*** – Managers can make changes if they believe the market may take a downturn.
- ***Complement weakness in index construction*** – Managers conviction-weight vs. capitalization-weight holdings.

Issues for Consideration

- ***Possibility of lower-than-index returns* –** Underperformance by active managers can be a significant detractor to overall performance.
- ***Higher fees and operating expenses.***
- ***Style issues may create additional volatility* –** A manager's style may be in or out of favor with the market.
- ***A DiMeo Schneider study (March 2007) shows that 90% of equity and fixed income mutual funds reviewed with top quartile results for the 10 year period ended December 31, 2006, had suffered through a below median stretch of three years or more during this time period.***

Passive vs. Active Portfolio Construction

Portfolio Construction

100% Passive

Passive / Active Blend
"Core-Satellite"

100% Active

Priority Objective
- Minimize return variability to market
- Lower expenses
- No manager selection risk
- After-tax efficiency

Priority Objective
Optimize the benefits and risks of index and active strategies

Priority Objective
- Opportunity for excess returns
- Willingness to assume:
  - Higher costs
  - Manager risk

Decision between passive / active management is based on:

1) ***Risk Tolerance*** – Sensitivity to variability in returns relative to the benchmark.

2) ***Return Expectations*** – Conviction of active management to deliver consistent performance premiums.

3) ***Time Horizon*** **–** Active management requires a longer-term time horizon and investors to be patient, or a more passively managed approach should be pursued.

Target Date Funds

Plan Sponsors have three actions to take when selecting Target Date Funds:

1. Choose Glide Path
   - To versus Through
2. Determine Asset Strategies
   - Active vs. Passive, and
   - Proprietary vs. Non Proprietary
3. Select or Design Benchmarks
   - Initial and Ongoing

Definition of a Target Date Fund*

Target date funds, which are also called lifecycle funds, are designed to offer a convenient way to invest for a person expecting to retire around a particular date. A target date fund pursues a long-term investment strategy, using a mix of asset classes (or asset allocation) that the fund provider adjusts to become more conservative over time.

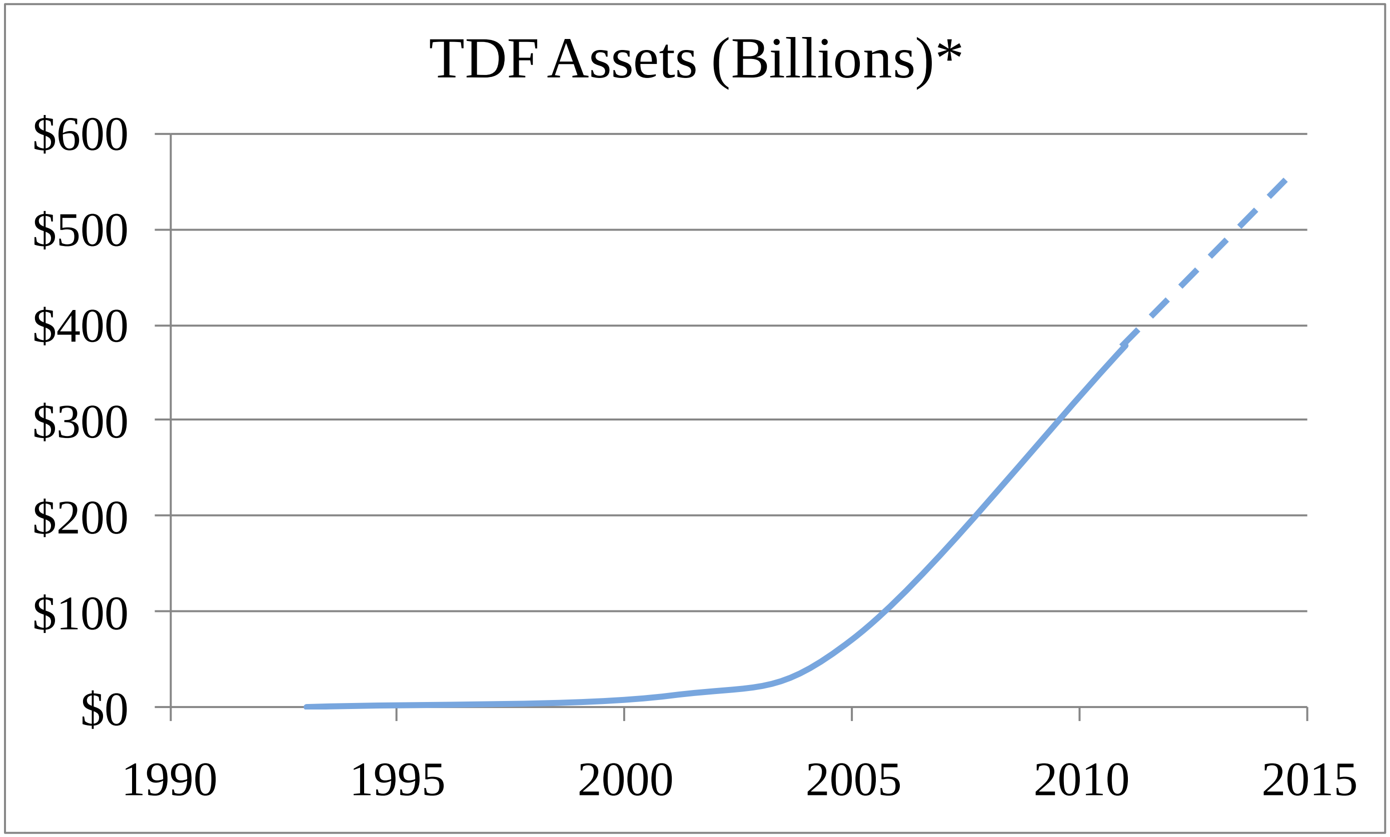
Target date funds are intended to help investors avoid the most common mistakes. Benefits can include:

- Diversification
- Avoid extreme asset allocations
- Automatic rebalancing
- Automatic adjustment for changing risk profile

*Investment Company Institute. Frequently Asked Questions About Target Date or Lifecycle Funds, 2012

Growth of Target Date Funds

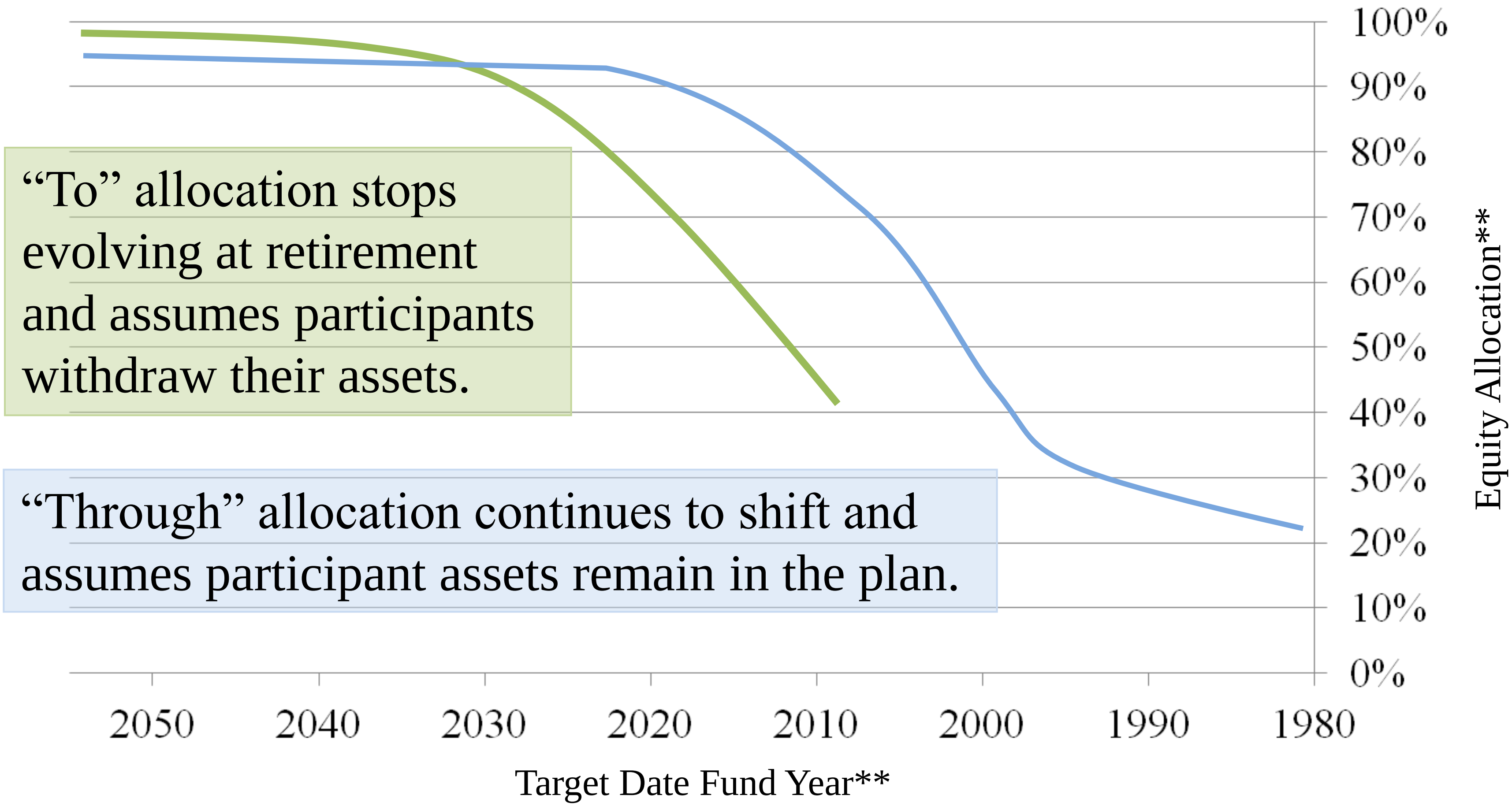
DOL regulations and §404(c)5 favor "portfolio" investments rather than single mutual funds for Qualified Default Investment Alternatives (QDIA).



*Morningstar Fund Research – May 2012 – Target-Date Series Research Paper: 2012 Industry Survey

Action 1. Choose Your Glide Path

The glide path is the asset allocation path that the TDF follows to become more conservative over time.*

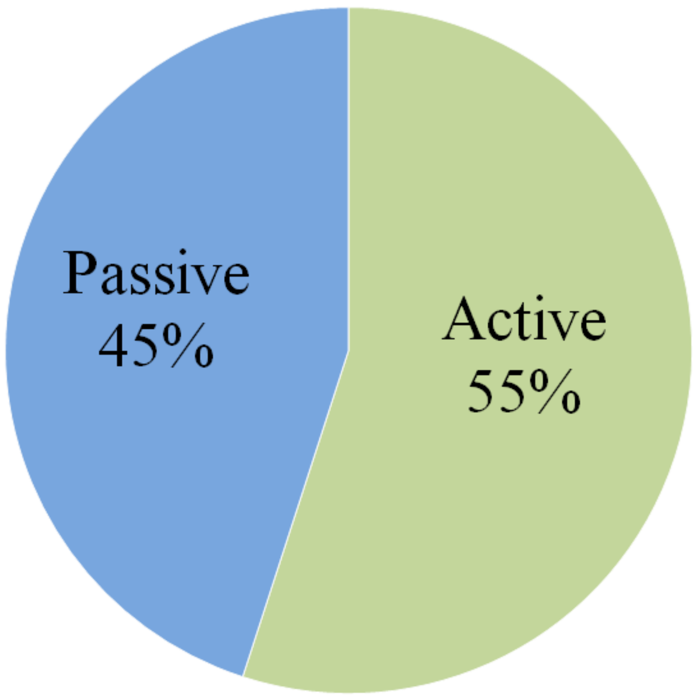


*Investment Company Institute. Frequently Asked Questions About Target Date or Lifecycle Funds, 2012

**Morningstar Fund Research – May 2012 – Target-Date Series Research Paper: 2012 Industry Survey

Action 2. Determine Asset Strategies: Active vs. Passive

*Prevalence of Passive vs. Active Strategies**



Considerations / Benefits

Passive	Active
Simplicity	Out Performance/ Under Performance
Transparency	Security Selection
Lower Costs	Risk Management

*Morningstar Fund Research – May 2012 – Target-Date Series Research Paper: 2012 Industry Survey

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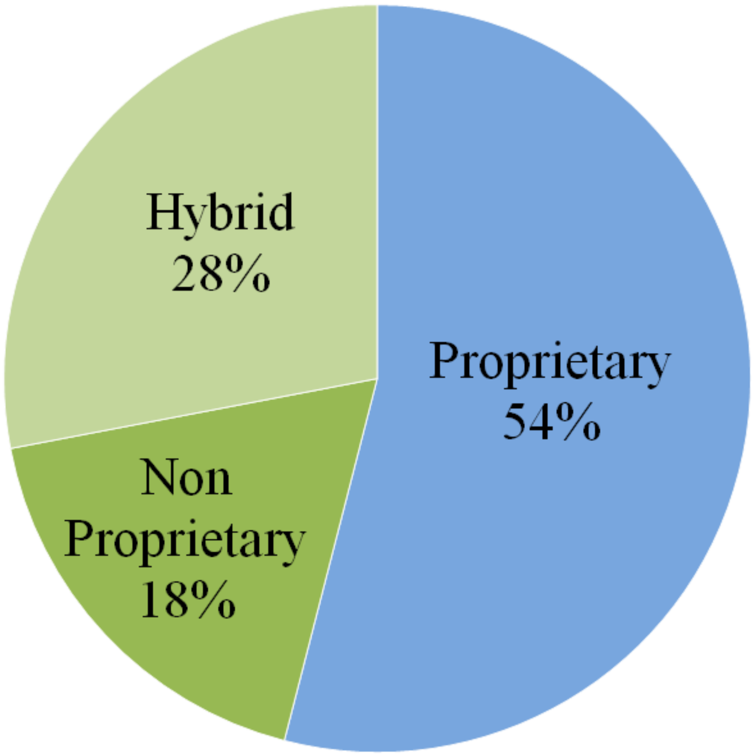
2. Determine Asset Strategies: Proprietary vs. Non-Proprietary

Considerations / Benefits

Proprietary	Non Proprietary
Integrated Solutions	Best of Breed
Larger Organization	Fund Family Diversity
Pricing Efficiencies	Control Fees

*Prevalence of Proprietary vs. Non-Proprietary Solutions**



*Morningstar Fund Research – May 2012 – Target-Date Series Research Paper: 2012 Industry Survey

Action 3. Select or Design Benchmarks

- Benchmarking selection and/or construction is of paramount importance. Many existing solutions are not adequate.
  - Glide Path—need consistency with peers
  - Performance attribution—consider impact of allocation and selection while being conscious of fees
  - Performance—be conscious of the short term but focus on the longer term
  - Risk—focus on risk adjusted performance

Key Points

Plan Sponsors have three actions to take when selecting Target Date Funds:

1. Choose Glide Path
    - To versus Through
2. Determine Asset Strategies
    - Active vs. Passive, and
    - Proprietary vs. Non Proprietary
3. Select or Design Benchmarks
    - Initial and Ongoing

What To Do Next

- Review your existing Target Date Funds
- Document why you have what you have
- Select or design your benchmarks
- Seek assistance if you do not have expertise

Thank You

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