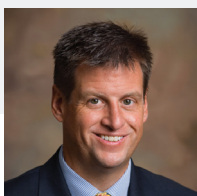




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Considerations for Plan Sponsors **CONSTRUCTING MORE EFFECTIVE DEFINED CONTRIBUTION INVESTMENT LINEUPS**

EXECUTIVE SUMMARY

- With defined contribution (DC) plans now serving as the primary vehicle for retirement savings in the U.S. and concerns continuing about workers' ability to reach their retirement goals, the structure of investment lineups has never been more important.
- Regulatory and fiduciary issues play important roles in shaping today's investment lineups. Adhering to Section 404(c) provides some liability protection for plan sponsors, and offering a qualified default investment alternative (QDIA) may also provide fiduciary relief. In any case, every investment option comes with monitoring obligations.
- Understanding cultural and employee demographics can help guide the construction of a lineup, particularly when it comes to the number and variety of options. As well, the presence of a defined benefit (DB) plan and the company's preference for a "paternalistic" or "individualistic" culture can help define an appropriate lineup.
- Research and industry trends, especially in the field of behavioral finance, are leading the way toward investment lineups that can achieve more positive retirement savings outcomes for participants.

This paper discusses seven key best practice considerations:

- 1.** Offer asset allocation products such as target date options as the default option.
- 2.** Offer either a stable value or a money market investment option.
- 3.** Consider expanding the fixed income offerings beyond U.S. Investment Grade.
- 4.** Provide the full opportunity set of U.S. equities, but keep the number of options low and minimize any overlap.
- 5.** Offer a diversified international equities option.
- 6.** Minimize sector and other specialty investment options.
- 7.** Consider a self-directed brokerage approach to appeal to highly engaged participants.

NEEDS HAVE CHANGED, AND SO HAVE THE TOOLS AND THINKING

As DC plans continue to grow in prominence as the sole retirement income source for many participants, plan sponsors are facing important decisions about how to construct lineups. These decisions can have a significant bearing on the interests of the employee population while also addressing fiduciary concerns.

Any review of a lineup should consider regulatory and fiduciary issues, cultural and employee demographics, and research and industry trends. This paper addresses each of these areas, and then offers seven key best practice considerations.

REGULATORY AND FIDUCIARY ISSUES ARE PLAYING A MAJOR ROLE

Of all the considerations for plan lineup design, fiduciary considerations are some of the most prominent. For example, even if participants are directing their own investments, the plan fiduciary may still be liable for these participant decisions unless the plan is a designated 404(c) plan and satisfies the applicable requirements for fiduciary protection. To qualify for protection under Section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA), the plan is generally required to:

1. Offer at least three different, internally diversified investment options with materially different risk and return characteristics.
2. Allow participants to transfer assets among the options at least quarterly.
3. Provide certain disclosures, including those required under ERISA section 404(a)(5), and access to sufficient information to make informed investment decisions.

Offering a qualified default investment alternative (QDIA) may relieve some concerns

Under the Pension Protection Act of 2006, fiduciaries are provided certain protections if they default participants into a QDIA. If plan sponsors wish to receive this limited protection, they should consider offering an investment option that qualifies as a QDIA using Department of Labor guidelines. Balanced funds, target date funds, and managed accounts¹ are types of investment options eligible for QDIA status.

Every investment option comes with monitoring obligations

Being fiduciaries, plan sponsors are tasked with selecting and monitoring the investment options available under the plan.

The greater the number and scope of investment offerings, the greater the time and resources needed to monitor them. This is particularly true with more esoteric asset classes, which can be more difficult to monitor due to their complexity. These monitoring obligations should be kept in mind when deciding the number and types of investment options offered in a plan.

CULTURE AND EMPLOYEE DEMOGRAPHICS SHOULD GUIDE OBJECTIVES

Plan sponsors should have a clear understanding of their plan's objective when determining its investment lineup. Each of the following factors plays a role in determining objectives.

Demographics can influence number and variety of options

Demographic factors such as age and level of education are factors that often determine a participant's level of investment knowledge or willingness to

access outside sources of investment knowledge and expertise. For plans with participants who may lack the knowledge or interest in researching investment option information, sponsors may consider limiting the number and variety of investment options.

Availability of a defined benefit (DB) plan may affect a sponsor's view on risk tolerance and breadth of investment needs in the DC plan

If an employer does not offer a DB plan or it is closed to new participants, the DC plan likely serves as the primary source of retirement income for many of the participants. This may lead some plan sponsors to decide that the amount of risk and variety of options in the DC plan should be limited to guard against market risk. Conversely, some plan sponsors might conclude that as the sole retirement income source, the DC plan should offer a full range of investment options and possibilities for participants to have a robust choice of options with which to design their own portfolios. Viewing the DC plan through the lens of the total retirement package available to employees can lead to varying perspectives on what an appropriate DC lineup should include.

Is the company "paternalistic" or "individualistic"?

Whether an employer promotes a paternalistic or individualistic culture often determines how limited or expansive plan sponsors choose to make a plan's investment lineup. Paternalistic employers may choose to limit the number of options to help avoid overwhelming employees with too many options. On the other hand, employers focused on individual choice may believe participants should not be restricted in their investment choices and may offer greater choice and variety.

¹A professionally managed account service that allocates contributions among existing plan options to provide an asset mix that takes into account a plan participant's age or retirement date is a type of QDIA.

RESEARCH AND INDUSTRY TRENDS ARE SHEDDING NEW LIGHT ON ISSUES

A great deal of research in the field of behavioral finance continues to be conducted on participant behavior and should be considered when evaluating investment lineups.

Many participants misunderstand risk and return

Participants often exhibit “myopic loss aversion,” meaning they are overly conservative and focused on the short term due to a fear of losses.² Others are overly confident and trade in and out of “hot” asset classes, believing they can generate superior returns.³

Such potential behavior should be considered by plan sponsors as they evaluate and revise investment lineups. Reducing the number of sub-asset class options may help eliminate these inappropriate behavioral problems while simplifying the management of the plan.

Too many choices could have undesirable consequences

Recent findings show that higher numbers of investment choices may reduce participation rates or encourage participants to simply choose the safest option, which may not always be in their best interest. In addition, studies have

shown that some participants tend to over-allocate to certain asset classes when more than one choice in the category is offered.⁴ Plan sponsors are responding by limiting the number of choices and by offering options such as target date or other asset allocation funds that allow participants to diversify their retirement savings without having to select individual funds that invest in specific asset classes.

Diversification doesn't come easy

According to research by behavioral finance researchers Shlomo Benartzi and Richard Thaler, many engage in what is referred to as “naive diversification,” where they allocate assets evenly across each of the investment offerings in the plan.⁵ Depending on the number and type of offerings in a plan, this can lead to overly concentrated portfolios or ones with a great deal of overlap in similar assets and securities.

Thoughtful structuring of the investment lineup may be the most effective action

By streamlining the choices and eliminating asset class overlaps, a plan sponsor can significantly reduce confusion for employees and consequently improve participation and

savings rates while helping them make more appropriate allocation decisions.

BEST PRACTICE CONSIDERATIONS: SOUND SOLUTIONS FOR EFFECTIVE INVESTMENT LINEUPS

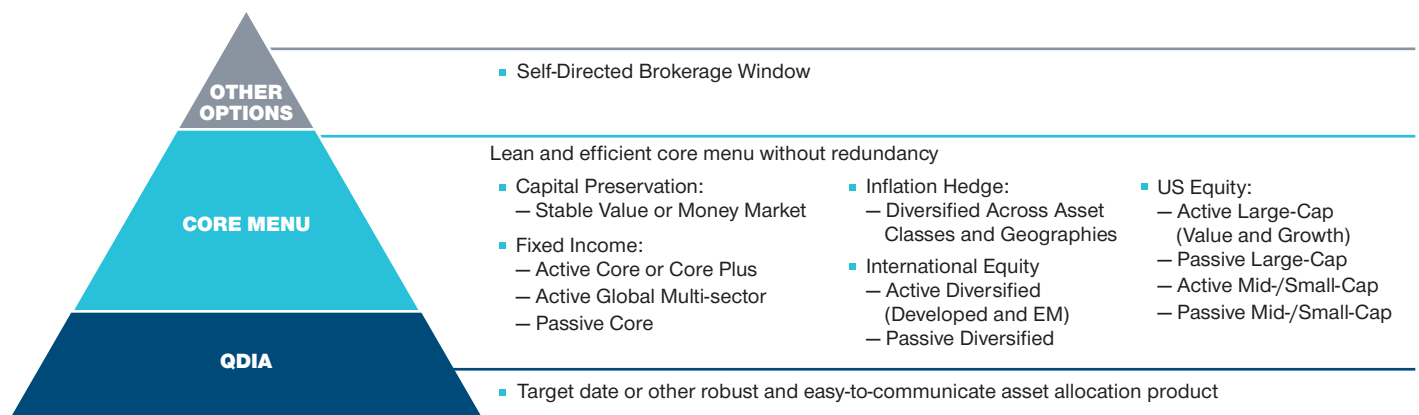
Given the issues discussed in the preceding sections, plan sponsors may want to consider using a “building block” approach to lineup construction (Figure 1). Start with a QDIA, such as target date options and a limited number of core options, and then potentially add a brokerage window if the plan wants to provide access to additional options. The goal of the core options block is to provide a sufficient number of choices to enable participants to construct a well-diversified portfolio while limiting overlap and unintended risk concentration.

When evaluating the following best practice considerations, keep in mind that no two plans are exactly alike. Employee demographics and sponsor goals vary, and circumstances may evolve over time.

1. Offer target date options as the default option.

Target date investment options can help satisfy the needs of participants who prefer not to make their own investment allocation decisions. They allow participants access to diversified

FIGURE 1: Sample Best Practice Lineup



²Benartzi, Shlomo, and Richard Thaler, “Risk Aversion or Myopia? Choices in Repeated Gambles and Retirement Investments,” *Management Science*, Vol. 45, No. 3, pp. 364-381, 1999.

³Liersch, Michael, “Choice in Retirement Plans: How participant behavior differs in plans offering advice, managed accounts, and target date investments,” 2011.

⁴Ibid.

⁵Benartzi, Shlomo, and Richard Thaler, “Heuristics and Biases in Retirement Savings Behavior,” *Journal of Economic Perspectives*, Summer 2007, Vol. 21.3.

portfolios in which professional managers make strategic and tactical asset allocation decisions. They also provide broad diversification and periodic rebalancing. Of course, diversification cannot assure a profit or protect against loss in a declining market.

The asset allocation strategy and underlying investments vary among target date investment managers, and plan sponsors should be aware of their target date investment option's approach and ensure that it matches their goals for the plan.

Within equities, the majority of target date investment options have dedicated allocations to U.S. large-, mid-, and small-capitalization stocks, developed international markets, and emerging markets. Within fixed income, most have allocations to U.S. investment-grade bonds, and some have allocations to U.S. high yield and international bonds. Additionally, many target date investment managers have been adding allocations to alternative, or nontraditional, asset classes, such as real estate, commodities, and Treasury inflation protected securities (TIPS).

Target date investments offer access to certain investments—emerging markets, real estate, commodities, and TIPS—that may not be appropriate as standalone options in a lineup due to their complexity and volatility. The advantage of gaining exposure to these types of investments via a target date investment option is that a professional manager makes the allocation decision. Most managers have target allocations that restrict the amount that may be allocated to an asset class. This generally prevents the type of performance chasing and over-allocating to “hot” asset classes

that can be seen in participant-directed portfolios.

The principal value of target date investment options is not guaranteed at any time, including at or after the target date, which is the approximate date when investors plan to retire. These investment options typically invest in a broad range of underlying mutual funds that include stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. In addition, the objectives of target date investment options typically change over time to become more conservative.

2. Offer either a stable value or a money market investment option.

Stable value and money market portfolios are the most conservative options offered in DC plans, as these portfolios are managed to maintain stable share prices, typically with a net asset value (NAV) of one dollar per share.

New regulations adopted by the Securities and Exchange Commission in 2014 will require institutional money market funds to have floating NAVs. Additionally, all money market funds, except government money market funds, must build the capability to impose liquidity fees and redemption gates in times of market stress. Based on these reforms, Plans may want to consider limiting their money market fund offering to a government money market fund, as it has a stable NAV and no fees or gates.

While money market and stable value portfolios share the goal of capital preservation, their underlying investments are different. Money market funds invest in short-term instruments, such as Treasury bills, negotiable certificates of deposit, municipal obligations, and both unsecured and asset-backed commercial paper. They can also encompass more complex instruments, such as

repurchase agreements (repos) and dollar-denominated foreign bonds. Stable value funds, on the other hand, typically invest in short- to intermediate-term fixed income securities that are insulated from interest rate movements by contracts from banks and insurance companies. The contracts generally allow price fluctuations in the underlying securities to be amortized over the duration of the contract, helping to stabilize overall returns and maintain an NAV of one dollar per share.

The difference in underlying investments for the two types of funds results in different risk and return profiles. Even though both seek to maintain a stable NAV of one dollar, money market funds are generally considered less risky than stable value funds. This is due to the shorter duration (sensitivity to interest rate changes) of their underlying investments.⁶ The return difference is primarily driven by the interest rate environment. Both the level and direction of interest rates will affect the return differential. Stable value funds are less interest rate responsive, but their longer duration provides return advantages in low or declining interest rate environments. Money market funds are more interest rate sensitive, allowing them to respond more quickly to changing short-term rates (Figure 2, page 5).

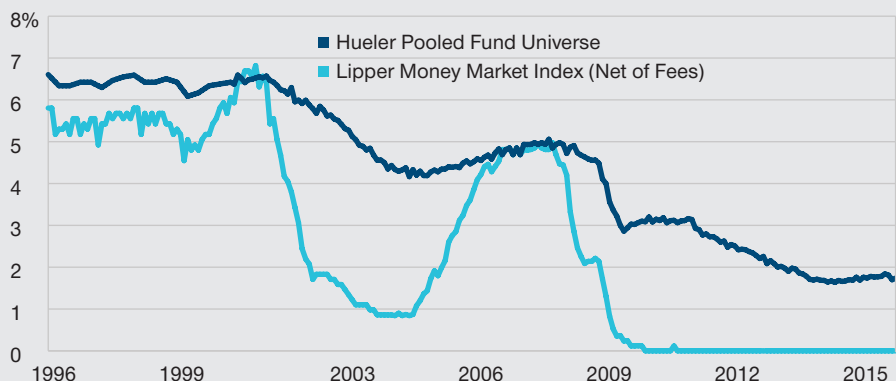
Plan sponsors should consider offering either a stable value or a money market fund. Since the primary goal of each is capital preservation, there is little to no diversification benefit by offering both options. Also, equity wash rules, which are contractual provisions applicable to stable value, typically require transfers that are directed to a competing option (such as a money market fund) to first be directed to a non-competing option for a set period of time.

⁶A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. Source: Investopedia.com.

Larger yield premiums for stable value funds over yields on money market funds are typically associated with low- and declining-rate environments for short-term securities. As those rates rise, however, the premium may diminish. For the yield advantage on stable value funds to actually turn negative would require an exceptionally harsh monetary climate, one in which short-term rates move higher than longer-term rates quickly and stay that way over a prolonged period. Such yield curve inversions have occurred but have been rare, short-lived, and only slightly negative.

FIGURE 2: Annualized Yields for Stable Value Funds and Money Market Funds

Through 30 September 2015



Sources: Hueler Analytics, and Lipper Inc.

You could lose money by investing in a Stable Value or Money Market Fund. Although the Funds seek to preserve the value of your investment at \$1.00 per share, they cannot guarantee they will do so. An investment in these Funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Funds' sponsors have no legal obligation to provide financial support to the Funds, and you should not expect that the sponsors will provide financial support to the Funds at any time.

3. Consider expanding the fixed income offerings beyond U.S. Investment Grade.

The “core” fixed income market is composed of U.S. Treasuries and government-related securities, mortgage-backed securities (MBS), investment-grade corporate bonds, commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS).

Core funds are typically benchmarked to the Barclays Capital U.S. Aggregate Index, which includes investment-grade U.S.-denominated bonds in each of these sectors (Figure 3, page 6).

Most core fixed income funds employ relative value strategies to identify the cheapest sectors and bottom-up security selection to identify securities within each sector. Other drivers of performance may include duration management (adjusting the portfolio’s sensitivity to changes in interest rates) and yield-curve positioning (forecasting moves in particular parts of the yield curve).⁷

In addition to the core sectors described above, the fixed income market includes out-of-benchmark sectors, such as nondollar bonds, leveraged loans, TIPS, emerging

markets bonds, and high yield securities. These “plus” sectors are more volatile than “core” sectors and will have periods of extreme over- and underperformance, making them problematic as standalone options.

Plan sponsors may want to consider offering just one core plus option that provides broad exposure to domestic bond markets along with select exposure to high yield, nondollar, and emerging markets bonds on an opportunistic basis.

Alternatively, sponsors may want to consider adding a diversified global multi-sector bond option as a complement to a core offering. This would allow participants to gain exposure to broader fixed income sectors without adding standalone niche offerings such as individual international bond or high yield options.

4. Provide the full opportunity set of U.S. equities, keeping the number of options low and minimizing overlap.

The U.S. equity market is typically the largest segment of DC participant portfolios and therefore poses a larger set of decisions for plan sponsors. U.S. equities are commonly divided into nine subcategories based on market capitalization and investment style (Figure 4, page 6). Each subcategory has its own risk/return profile and generally can be expected to perform differently during various market and business cycles. The goal is to provide participants adequate exposure to the full opportunity set. How a sponsor chooses to accomplish this will vary.

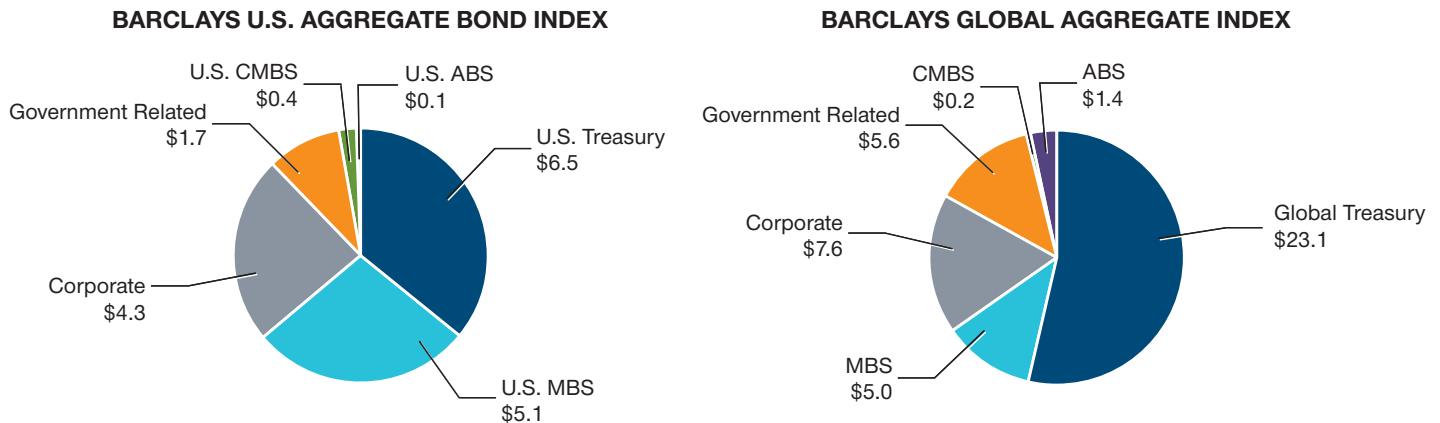
Covering market capitalizations

At a minimum, a plan sponsor should provide one broadly diversified large-cap option that tracks an index like the Russell 1000 or the S&P 500. Since these large-cap options make up 76% to 90% of the total value of the U.S.

⁷Investopedia.com: “The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.” Up or down movements along the yield curve will result in price changes of similar bonds with different maturities. This can affect performance.

FIGURE 3: Global Investment-Grade Bond Universe Is \$44 Trillion

As of December 31, 2015



For illustrative purpose only. Individual investment options may vary.

equity markets depending on the index, this one option can provide participants reasonably adequate exposure to the U.S. equities market. However, due to diversification benefits and risk/return variation, participants may benefit from exposure to mid- and small-cap options as well.

Providing exposure across all capitalizations may be best accomplished with an option for each capitalization. This would allow participants additional choice and control of their equity allocation without greatly increasing the number of options. It also allows the plan to choose options that specialize in their particular market cap segments and to reduce the risk that one option might not perform well.

Covering equity styles

A plan sponsor may use core (blend), style-specific, or a mix of choices. Here are some pros and cons of each:

- **Core (blend).** By offering only a core option for each capitalization, sponsors are keeping with the theme of limiting the number of options while still allowing access to equities from each market capitalization. This limits

participants' need to make decisions and allows professional managers to decide whether to over- or underweight certain investment styles. One disadvantage is that managers may drift to one style for an extended period, thus limiting the participants' exposure to other styles.

- **Style-specific.** By using style-specific options, plan sponsors are allowing participants to make tactical allocation decisions between value and growth. When adding these options, sponsors need to pay particular attention to the strategies and provide education to participants on the differences. This is particularly important with small-cap equities, as these value and growth funds tend to have significant sector concentrations that increase their volatility.
- **Mix of core and style-specific.** Sponsors do not have to take the same approach for each market capitalization. For example, a sponsor may want to offer style-specific for large-cap and mid-cap exposures but a core for small-cap. The key is to avoid offering both style-specific and core in the same market capitalization, which can lead to more confusion

and chances for overlap within participant portfolios.

5. Offer a diversified international equities option.

International equity markets have grown significantly in recent years and now compose about 60% of the world's market capitalization. This means the asset class is becoming an increasingly important part of a well-diversified participant portfolio.

Recognizing the growing opportunity set outside the U.S., the 401(k) industry has increased its attention on international options. A number of plan sponsors have

FIGURE 4: Equities Style Box[®]

Large-Cap Value	Large-Cap Blend	Large-Cap Growth
Mid-Cap Value	Mid-Cap Blend	Mid-Cap Growth
Small-Cap Value	Small-Cap Blend	Small-Cap Growth

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recently expanded their international offerings beyond the typical broad-based options to include those that are style-specific (growth and value), market cap focused, or dedicated to emerging markets.

While these offerings have investment merits, plan sponsors need to balance the benefits with the potential difficulties. Will participants have the ability to utilize the options appropriately? Will they understand the risks? Will the increased number of options cause confusion?

Plan sponsors who determine that the benefits outweigh the difficulties and decide to offer multiple international options should:

1. Avoid overlap with the plan's other international options.
2. Provide additional education on the options' differing risk/reward profiles.

Education is especially crucial when adding dedicated emerging markets and small-cap options, which are traditionally more volatile.

Plan sponsors who are not comfortable with the difficulties of adding more international choices should consider offering a single diversified international option. Preferably, the option would have a dedicated portion of its portfolio in emerging markets as those markets continue to grow and become a larger part of the global capital markets. Through this one international option, participants will have sufficient access to the benefits of international equities, but without the confusion of multiple choices.

6. Minimize sector and other specialty investment options.

The objective of a sector fund is to invest the majority of assets in a single sector of the economy, such as technology, energy, or real estate. While these sectors can have high return potential, they are generally more volatile than the broad market due to their concentrations. Many have wide swings in performance that can result in large participant flows in and out. The same is true of specialty strategies like gold and precious metals.

A number of plans have recently added inflation-hedging options that focus on real estate, commodities, infrastructure, and

TIPS. While these investments—as well as other sectors and specialties—have merits, providing them as standalone options may not be the best way to provide access in a retirement plan.

The concern is that participants will misjudge the risks associated with these funds and over-allocate to them, resulting in undiversified portfolios with large unintended levels of risk. It is better to allow participants exposure to the various sectors of the economy through diversified funds. This way, professional managers are deciding the sector and specialty allocations and generally limiting sector concentrations.

7. Consider a self-directed brokerage approach to appeal to highly engaged participants.

The final block of the plan lineup is the self-directed brokerage option. This provides access to additional investments for more sophisticated investors while reducing the number of options that might confuse or increase allocation risks for less sophisticated investors. Those participants who want dedicated allocations to sector or regional funds can find those via the brokerage option.

PROVIDING ACTIVE AND PASSIVE CHOICES

The financial industry has long debated the merits of active versus passive management. As the debate will undoubtedly continue, it's important to keep in mind that advocates on each side have valid arguments and supportive data—and most plans are likely to have believers on both sides. This being the case, plan sponsors may want to consider providing index choices to complement certain actively managed options, and vice versa.

Historically, most plans have included only one passive option in their lineup, typically a large-cap U.S. equity fund tracking the S&P 500 Index. The 401(k) industry has seen a recent trend of sponsors expanding the menu of index options to areas such as fixed income, international equities, and broader mid- and small-cap sectors of the U.S. equity market.

Sponsors should always be mindful, however, of potential problems caused by loading a plan with too many choices. Participants may find the array of options confusing and, therefore, allocate in ways that create unintended or inappropriate weightings for their needs. Or worse, they find the investment decision overwhelming and may delay participating.

As with all options in the investment lineup, best practices would dictate avoiding overlap in any market areas and insuring that the investment menu is clearly and effectively communicated to participants. Specifically, identifying options as actively or passively managed is recommended so that participants can readily identify the differences in the management style and make informed decisions based on their unique needs and preferences.

Plan sponsors may want to limit the brokerage window to only mutual funds, since individual securities introduce new levels of risk for participants. This capability to limit the access may not be available through every service provider.

Offering a brokerage window may result in additional fiduciary oversight obligations and so, as with all potential lineup enhancements, the pros and cons must be thoughtfully considered. Plan sponsors should also be aware that the U.S. Department of Labor is considering whether regulatory guidance on fiduciary

requirements and safeguards for offering brokerage windows is appropriate.

CONCLUSION

To help participants make the most of their 401(k) plans, a plan sponsor may want to reevaluate the plan's investment lineup and make changes aimed at encouraging better decision-making by participants.

Every plan has its own unique circumstances, so it is important to evaluate the investment lineup in a thorough and professional way, taking

into consideration the needs of both the plan sponsor and the employee base.

The best practice considerations presented in this paper serve as a good starting point to identify structures that can increase plan effectiveness—and potentially improve retirement outcomes.

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Appendix

ASSESSING A CURRENT LINEUP

The following questionnaire may help identify potential problem areas within a plan’s investment lineup. It is important to understand that a “yes” or a “no” answer is not necessarily right or wrong. Any proposed plan change should be consistent with the needs of the plan’s employee population, taking into account their long-term financial needs as well as their behavioral characteristics, and, if applicable, the plan’s investment policy.

APPENDIX FIGURE 1: DC Investment Lineup Assessment

	Yes	No	Considerations
Does the plan provide a diversified QDIA option?			
Does the plan offer more than one “short-term” investment option (stable value or money market option)?			
Does the plan offer sufficient coverage of the global fixed income markets?			
Does the plan offer sufficient coverage of the international markets?			
Does the plan offer sufficient coverage of the U.S. equity markets?			
Does the plan offer more than one option in any specific asset class?			
Does the plan offer both active and passive options in the major market classes?			
Does the plan offer sector funds?			
Does the plan offer a brokerage window?			

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