White Label 2.0

Lessons learned can provide insights to improve the concept.

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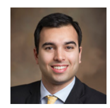
KEY INSIGHTS

- Many defined contribution plans are adopting white-label offerings—unbranded portfolios that may have single or multiple managers, asset classes, or styles.
- When properly designed and constructed, white-label offerings may help plan sponsors balance competing objectives such as diversification and plan simplicity.
- First-generation white-label programs may not have achieved desired results. Problems have included poorly designed offerings that failed to meet objectives.
- T. Rowe Price believes there is an opportunity for plan sponsors to improve the design of their white-label offerings—a concept we call “White Label 2.0.”



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In their efforts to simplify their investment lineups while preserving diversification, a growing number of defined contribution (DC) plan sponsors are creating their own “white label” investment solutions—unbranded offerings that can include single or multiple portfolio managers, asset classes, and/or investment styles.

A number of DC plan sponsors have looked to white-label solutions to:

- simplify their plan’s investment menu and reduce choice overload for participants;
- employ more sophisticated portfolio construction techniques;
- embed additional potential sources of value, such as tactical asset allocation, in their offerings;
- provide exposure to niche asset classes without the need for dedicated investment options;
- leverage their plan’s size and buying power.

However, many DC plan sponsors have experienced mixed results with their initial white-label offerings. The first generation of white-label portfolios have not always fully achieved the results that plan sponsors expected.

We understand that it is up to each plan’s investment committee to decide whether the benefits of adding white-label options to their lineup will justify the additional fiduciary oversight responsibilities, potential resource needs, and administrative costs involved. Every plan’s situation is unique, and there is no single “right” answer.

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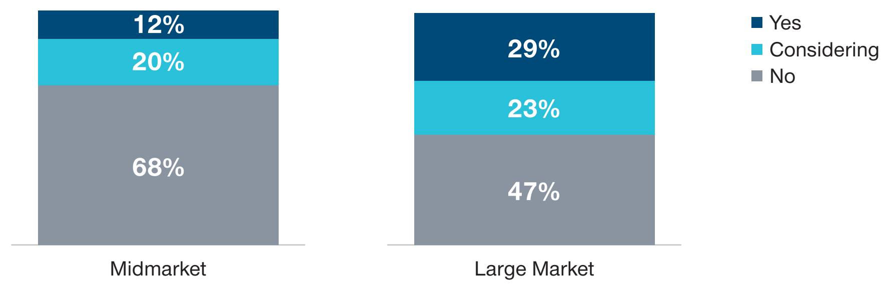
(Fig. 1) Some Large DC Plan Sponsors Are Adopting White-Label Offerings

Does your plan currently offer white-label investment options?[1]



Survey data as of April 2017.
Source: Institutional Investor Institute for Defined Contribution.
[1] For midmarket plans, "Considering" (20%) combined responses "No, but are in progress to implement them within 1 year" (4%) and "No, but we are talking about whether to do so" (16%). For large-market plans, "Considering" (23%) combined responses "No, but we intend to" (3%) and "No, but we are talking about whether to do so" (20%). Totals may not add to 100% due to rounding.

> White-label vehicles can reduce the number of investment choices participants face while still offering diversification opportunities.

However, if plan sponsors do believe that the white-label approach is appropriate, we think there are ways to build on what has worked in white-label design while refining those areas that may have presented challenges. We call this opportunity to revisit and potentially enhance the white-label concept "White Label 2.0" and believe it offers a way to streamline the investment options that are offered to participants.

T. Rowe Price's ongoing partnerships with DC plan sponsors have made it possible for us to assess the investment structure of a number of initial white-label offerings. These examinations have produced some valuable lessons and uncovered potential opportunities to improve portfolio design.

In this paper, we will discuss best practices in portfolio design for consideration by those offering or considering white-label portfolios.

Reevaluating White-Label Strategies

White-label vehicles can reduce the number of investment choices participants face while still providing diversification opportunities. White-label offerings also can give sponsors the flexibility to align their plan offerings with either traditional or thematic investment strategies:

- Traditional investment strategies may focus on broad asset classes, such as diversified fixed income or global equity, on sub-asset classes or sectors, such as U.S. large-cap or emerging market equity, or incorporate multiple assets and styles.
- Thematic offerings can be designed to prioritize specific investment objectives, such as inflation protection, long-term portfolio growth, diversified income, or volatility management, as examples.

However, DC plan sponsors have faced numerous challenges when implementing white-label strategies. These challenges, outlined in Figure 2, suggest that DC plan sponsors and their investment advisors may want to consider refining the areas that may have presented problems in the first generation of white-label programs.

An Enhanced Approach to Portfolio Design

Analyzing first-generation white-label portfolios has shed light on opportunities for enhancement. Our research has shown that the first step

(Fig. 2) Challenges in First-Generation White-Label Implementation

Potential Missteps	Potential Consequences
Under-diversification	Some first-generation white-label portfolios have failed to take advantage of the full investment opportunity set.
Over-diversification	Redundant and/or suboptimal portfolio exposures have lowered return potential and raised costs for some offerings.
Misalignment With Objectives	Poorly defined objectives have resulted in mis-specified investment allocations for some plans, leading to disappointing results.
Concentrated Risk Exposures	Excessive or undesired portfolio risks may have produced outsized or unexpected investment losses.

Source: T. Rowe Price.

toward realizing the full benefits of a white-label portfolio is enhancing the approach to portfolio design. Figure 3 outlines the three elements we believe are essential to achieving this. By setting purposeful portfolio objectives, leveraging comprehensive portfolio construction techniques, and setting success metrics that are then regularly evaluated and monitored, we believe that plans can take a step toward achieving White Label 2.0 status.

The first step in the portfolio design process should be defining clear and plan-appropriate **portfolio objectives**. Plan sponsors should continue to reflect upon first-generation considerations such as desired asset class exposures, but it is also important that they weigh additional factors such as targeted portfolio characteristics including risk and fee budgets, the target benchmark, and the role of each white-label portfolio within the plan's full investment lineup.

(Fig. 3) The Three Essential Elements to Enhanced Portfolio Design

Setting Purposeful Portfolio Objectives

- Clearly define the role of the white-label portfolio within the plan lineup
- Be aware of the potential trade-offs between total returns, benchmark-relative returns, and outcome-oriented objectives

Ensuring Comprehensive Portfolio Construction

- Use multiple analytical techniques to ensure robustness and durability
- Assess investment components both individually and collectively
- Incorporate less correlated diversifying elements
- Target the right balance between diversification and upside excess return potential

Continuously Assessing and Validating

- Evaluate underlying investment strategies in the context of the portfolio's overall risk and return profile
- Carefully assess portfolio risks to confirm that exposures are intentional and compensated with appropriate levels of potential return
- Test the appropriateness of the initial structure and developing a plan for continued monitoring

Source: T. Rowe Price.

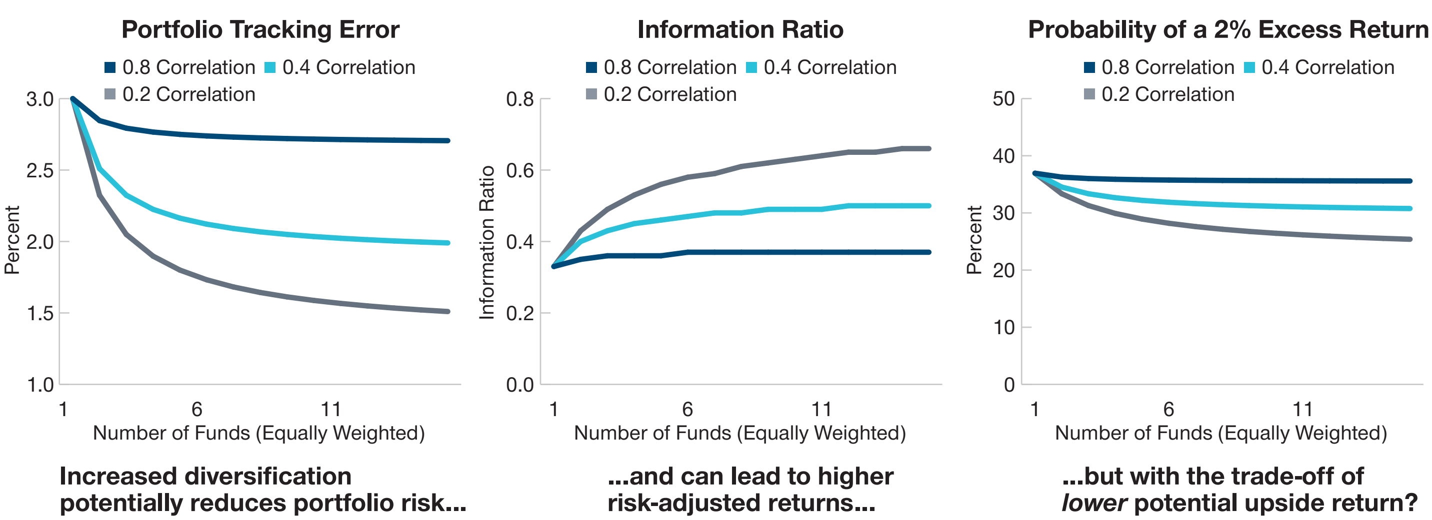
Once clear and purposeful objectives have been determined, attention can be turned to **portfolio construction**. What underlying investment strategies are best suited to achieving the plan's objectives? And how should those investment strategies be sized? Given how critical these questions are to the success of a white-label mandate, this analysis should be conducted in a very thorough manner. In our view, a thorough analysis requires the use of multiple analytical techniques to ensure that no single set of assumptions or modeling methodologies determines the portfolio's design.

Additionally, when constructing white-label portfolios, we believe that there are two principles that DC plan sponsors should consider:

- The **robustness and durability** of the plan's offerings. Multiple analytical techniques and stress tests should be incorporated in the design process to avoid potential biases from any one approach. By analyzing the interaction of portfolio assets across a variety of market scenarios, plan designers can seek to ensure that the portfolio will not be dependent on a single market environment to deliver acceptable results. However, this also requires plan sponsors and their advisors to continually revalidate the appropriateness of portfolio design through time.
- The need to **assess investment components both individually and collectively**. A proposed allocation should be validated both on its own merits and in terms of the potential benefits for the total portfolio. This requires a careful examination of whether each proposed strategy adds value to the total white-label portfolio. The key goal is to avoid design flaws such as naïve diversification or over-diversification. See Figure 4 for additional information about this.

Finally, an important lesson learned from the first generation of white-label portfolios is the need to **continually assess and validate** the portfolio over time. Success metrics need to be determined and a plan developed for ongoing monitoring of the investment structure.

(Fig. 4) The Impact of Diversification in a Hypothetical White Label Offering[1]



As of March 2021.
Source: T. Rowe Price.
[1] The above analysis uses fixed assumption values and considers a hypothetical scenario combining individual strategies that each have a 1.0% expected excess return, a 3.0% tracking error, and constant correlations to each other. The correlation assumption was varied across the 3 scenarios (0.8, 0.4, and 0.2, respectively) to illustrate the diversification benefits and considerations. The results do not represent the performance of any specific indexes or investments.

(Fig. 5) The T. Rowe Price Approach

We use a wide range of analyses to assess the suitability and sizing of the strategies within our white-label portfolios.

Examples of Questions T. Rowe Price Asks	Some of the Analytical Tools We Use
How do we expect the strategy to interact with other investments?	▪ Absolute and/or excess return correlation analysis ▪ Conditional performance analysis
Can the strategy potentially provide a diversified source of return and/or alpha?	▪ Returns-based and holdings-based factor analyses to understand performance drivers ▪ Statistical risk modeling/principal component analysis (PCA)
How do we size the strategy in relation to the other investments in the portfolio?	▪ In certain asset classes, such as equities, this may be driven by benchmark weight ▪ Historical and forward-looking risk, return, and correlation metrics

Source: T. Rowe Price.

"Our experience working with DC plan sponsors has underscored the important point that there is no one-size-fits-all approach to white-label programs.

Portfolio Construction and the Implications of Diversification

Figure 4 illustrates the trade-off between diversification and upside return potential in a hypothetical white-label offering. Beginning with a single-asset portfolio, we see that the benefits of diversification—in the form of reduced tracking error—increase as we add more funds or if correlations among those funds decline. If all of the funds have similar expected return profiles, then the reduction in tracking error should translate into a better expected information ratio. However, the trade-off is that greater diversification potentially limits the probability that the portfolio will *exceed* the expected return target.

White Label 2.0 in Practice

T. Rowe Price's multi-asset team has worked with a number of DC plan sponsors in the design and construction of white-label portfolios. Several recent case studies may offer insights into how initial white-label offerings can be modified to better meet plan and participant objectives.

- **U.S. Large-Cap Portfolio Allocation:** Disappointing relative returns led a large U.S. corporate DC plan to seek help in analyzing the allocation's structure. The portfolio included equally weighted exposures to four active U.S. large-cap strategies, yet underperformed the Russell 1000 Index. Using a variety of optimization techniques, we recommended reweighting active strategies to improve diversification and reduce structural biases.

- **U.S. Large-Cap Core Portfolio Construction:** A large U.S. corporate DC plan sought to simplify offerings to participants while maintaining familiar investment strategies. The client's preference was for a U.S. large-cap core strategy aligned to the Russell 1000 Index, but with the ability to implement shorter-term tactical style tilts. Based on our analysis, we developed and now manage for the plan a balanced portfolio that incorporates the client's desired constraints.

Our experience working with DC plan sponsors has underscored the important point that there is no

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one-size-fits-all approach to white-label programs. Understanding participant objectives and the many challenges they face in reaching those objectives should influence both the analysis and solution.

Conclusions

Designing investment lineups for DC plan participants requires plan sponsors to offer an appropriately diverse selection of funds while not confusing participants with too many choices. In theory, the white-label approach can help plan sponsors find an appropriate balance between these competing objectives.

However, first-generation white-label programs have not always lived up to the concept's potential. Poorly defined objectives, suboptimal portfolio allocations, unexpected and/or unwanted risk exposures, and high investment costs have led to disappointing results for some plans and their participants.

Based on our recent work with our DC plan clients, we believe an opportunity exists to reset the white-label concept—a project we call "White Label 2.0." By carefully analyzing and learning from the problems experienced to date, we think plan sponsors can make small changes to existing white-label product designs or design and construct new white-label programs that are effective and beneficial for participants. In our view, key elements of an improved approach include:

- a focus on long-term objectives, minimizing the distraction of short-term market fluctuations;
- the expanded use of analytical tools and techniques to better understand portfolio exposures;
- evaluating the underlying strategies both individually and in the context of the broader portfolio;
- assessing participant preferences, such as tolerance for risk, when determining portfolio parameters;
- continuously reassessing current investment dynamics to determine if the portfolio is still positioned to meet the sponsor's objectives.

In our view, the issues discussed in this paper highlight the fact that the white-label approach is a resource-intensive endeavor that requires careful planning, prudent portfolio construction, and constant monitoring in order to meet stated objectives.

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