Putting All Your Eggs in One Basket?
Evaluating and Choosing Single Option Funds for Your Plan’s Investment Menu

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Goals and Objectives for Today
- Understand DC investment menus and the current market for “All-in-one Funds”
- Defining some critical issues to consider when selecting an “All-in-one Fund”
- Look at the future of “All-in-one Funds”
DC Investment Menus and the Current State of “All-in-one Funds”

DC Core Investment Menu

- Common core menu structure
  - Equities (US, Int’l, Emerging Mkts)
  - Fixed Income (Core Bond, stable value/money market)
  - Real/Alternative Assets (sparely)
  - Important repercussions for custom target date approaches!
- Home Country Bias in participant asset allocations
  - Most plans traditional offer only one to 2 international options
  - 82% of equity allocation to US based stocks
  - Over-allocation by 33% versus global equity indexes (Source: Northern Trust, Feb 2015)
- Lack of fixed income options in DC lineups
  - Generally, an average of 3, versus 10 on the equity side (Source: Prudential Retirement Insights, Feb 2015)
  - Core Bond Fund - Focus on high quality, low volatility securities, not as much on high yield, bank loans and emerging market debt

Multi-Asset Portfolio Approaches

- Global Exposure
  - Most effective capture of the opportunity set
  - Tie in capital market assumptions (e.g. global bond return forecast?)
  - Diversification (through extending the opportunity set)
  - Strategic vs. Tactical allocations
- Purposeful Currency Exposure
  - Hedge your portfolio for currency risks
  - Tilt to potential trends (e.g. Great = weaker Euro = stronger dollar?)
- Active vs. Passive
  - Passive has had a good run of late
  - Active clearly has a role, especially with the stock market highs, and low bond yields, Time to tilt to more active?
  - Active returns = market beta + factor beta + alpha
Target Date Fund Approaches

- **Global Exposures**
  - Typical TDFs is 68% allocated to US equities (Source: Morningstar)
  - Exposure to global equities and bonds
  - Tactical approaches becoming more common (Source: Morningstar)

- **Diversification**
  - More focus on real assets (e.g., commodities, real estate, infrastructure)
  - Unconstrained fixed income
  - More focus on hedge funds, private equity

- **Active vs. Passive**
  - More funds adding passive strategies; price pressure a prime reason
  - More plan sponsors adopting passive TDFs; again, focus on fees

- **“To” versus “Through” glide paths**
  - Sequence risk at retirement
  - “To” glide path seems to deal with this risk better

Critical Issues to Consider

Is your Target Date aligned to your plan objective?

#1 Ranked Target Date Fund Objective

Maximize asset returns while minimizing volatility relative to the retirement liability
Your retirement income cost (liability) is a moving target!

- Retirement Income Cost (LHS)
- 10Y Real Rate (RHS)

From the low to the peak, the difference is ~$150,000 (2X final pay).

Your retirement income cost (liability) is a moving target!

As of 31 March 2015; SOURCE: PIMCO, Bloomberg and Haver Analytics.

Hypothetical example for illustrative purposes only.

Assumptions:
1) a participant has $75,000 in final salary regardless of the time period;
2) his goal is to achieve a 30% income replacement rate after retirement.

The retirement income cost is calculated as the discounted present value of the 20-year annual income stream of $22,500 by using the historical zero-coupon U.S. TIPS yield curve.

Market average glide path correlation to retirement liability

Average correlation: 0.4

Correlation to Retirement Liability

Jan-07 Jan-08 Jan-09 Jan-10 Jan-11 Jan-12 Jan-13 Jan-14 Jan-15

Correlation: 0.7 0.6 0.5 0.4 0.3 0.2 0.1 0.0 0.3 0.2 0.1 0.0

Role of asset classes change in a retirement income aware approach

- Absolute Risk*:
- Risk relative to Retirement Liability**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Absolute Risk</th>
<th>Risk Relative to Retirement Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>3m T-Bill</td>
<td>0.6%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Barclays Capital U.S. Aggregate Index</td>
<td>3.1%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Long TIPS</td>
<td>10.7%</td>
<td>10.7%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>4.3%</td>
<td>4.3%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>14.2%</td>
<td>14.2%</td>
</tr>
</tbody>
</table>

* Absolute risk: Standard deviation of monthly returns of asset class;
** Risk relative to Retirement income: Standard deviation of surplus returns over retirement income from February 2004 – March 2015 (Retirement liability is calculated as the discounted present value of the 20y liability stream by using the zero-coupon U.S. TIPS yield curve).

Long TIPS represented by Barclays U.S. TIPS Index > 10 yrs, cash represented by BofAML 3 Month US T-Bill Index, stocks represented by the S&P 500 Index, bonds represented by the Barclays U.S. Aggregate Index.
An objective aligned glide path seeks:
Wealth Maximization, Diversification and Retirement Income Hedging

Retirement Objective-Aligned Glide Path

Wealth Maximization, Diversification, and Retirement Income Hedging

Market average glide path

Median (Expected outcome)
Insufficient outcomes (shortfall risk)
Excessive outcomes (extreme winners)

The Ultimate Goal:
Improving retirement outcomes for ALL participants

The Future of “All-in-one Funds”?
### The Changing Defined Contribution Marketplace

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>New Paradigm</th>
<th>Current Paradigm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>Homogeneous</td>
<td>Diverse</td>
</tr>
<tr>
<td>Success Metrics</td>
<td>Accumulation</td>
<td>Retirement income for life</td>
</tr>
<tr>
<td>Communications</td>
<td>Generic</td>
<td>Personalized, interactive</td>
</tr>
<tr>
<td>DC Investment Options</td>
<td>More is better</td>
<td>Fewer, focused, institutional</td>
</tr>
<tr>
<td>Automation</td>
<td>As starting point</td>
<td>As complete path, with guidance</td>
</tr>
<tr>
<td>Investment Decisions</td>
<td>Information</td>
<td>Advice, managed solutions</td>
</tr>
<tr>
<td>Fees</td>
<td>“It’s free”</td>
<td>Per head, baseline</td>
</tr>
<tr>
<td>Risk</td>
<td>Bi-polar</td>
<td>Understood and managed</td>
</tr>
</tbody>
</table>

**Ultimate Goal – Improving Participant Outcomes**

### Partial Target-Date Fund Usage Negatively Impacts Returns

- Partial target-date fund users earned over 200 basis points less than full target-date fund users and managed accounts users.

**Source:** Financial Engines and Aon Hewitt study Help in Defined Contribution Plans: 2006 through 2012. Annual returns are based on actual participant performance.

### Leveraging DC Plan Size and Scale to Aid Participants

<table>
<thead>
<tr>
<th>Institutional/Separately Managed Funds</th>
<th>Change Fund Options to Reduce Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of the rest, 10% are very likely and 22% are moderately likely to change</td>
<td>Of the rest, 34% are very likely and 34% are moderately likely to change</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Add a Tier of Index Options</th>
<th>Move to Customized Target-date Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of the rest, 8% are very likely and 24% are moderately likely to add</td>
<td>Of the rest, 3% are very likely and 21% are moderately likely to move</td>
</tr>
</tbody>
</table>

**Very likely percentages are among those who do not already offer.**
Custom Target Date Funds

What? Custom TDFs are fully open architecture target date funds, which allow for customization to include better diversified asset allocations, a best-in-class lineup of fund managers, and the glide path designed with your participants in mind to govern how those asset allocations and funds will adjust over time.

Why? Plan sponsors are able to monitor and adjust these custom TDF elements just as they do for the other aspects of their defined contribution plan investment structures, and the plan participants benefit from having TDFs that are more responsive to their needs.

Who? 13% of plans currently offer custom TDFs. Of those that do not, 11% are likely to change the approach in the next 12 months.*

Source: AonHewitt 2013 Trends & Experience in Defined Contribution Plans
The Role of Alternative Assets in DC Plans

This results in a decrease in expected returns by 50-70 bps in the ranges of volatility where most TDFs are (6-18%), which can translate to over $100,000 over the course of a 40-year career.

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<table>
<thead>
<tr>
<th>Time for DC Plans To &quot;Go Big!&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>HEX Capital Market Assumptions:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Equity/Bonds</td>
</tr>
<tr>
<td>Private Equity</td>
</tr>
<tr>
<td>Real Estate</td>
</tr>
<tr>
<td>Hedge Fund of Funds</td>
</tr>
</tbody>
</table>

Alpha capture can be consistently meaningful
- Evidence suggests that superior alternative managers continue to be superior in the future and higher costs are at least earned back
- Private equity – Kaplan and Schoar
- Real estate – Tomperi
- Hedge funds – Jagannathan, Malakhov and Novikov
- Investors must have "skill at finding skill" – is manager selection is of critical importance

Private Real Estate – Why Now?

- Viable daily priced investment options are now available
- Universe of daily priced real estate funds has grown significantly since 2010
- Two major developments have supported the market evolution:
  - Structural fund evolution that addressed historic challenges
  - Shift in DC plans towards professionally managed platforms

- Only 26% of DC Participants have the option to invest in Real Estate
- Allocations average 1% and ultimately exclusively to REITs*

* Source: PSCA's 56th Annual Survey of Profit Sharing and 401(k) plans, 2013 Trends & Experience in Defined Contribution Plans.
Benefits of Adding Private Real Estate

- Represents real estate Beta (i.e. Core strategy) – Pure real estate play vs. REITs
- Funds provide access to the benefits of Private Real Estate:
  - Attractive absolute risk-adjusted returns
  - Stabilized & attractive income yields
  - Pure real estate play
- For DC investors the benefits of adding Private Real Estate are as follows:
  - Stability & higher risk-adjusted returns to balanced asset portfolio
  - Diversification & improved risk & liquidity management
  - Core Real Estate: 100% Direct Real Estate
  - Core & Core-Plus: 50% - 60% Direct Real Estate, 20% - 40% REITs & Cash

Structural Evolution in Real Estate Funds

- Broader opportunity set of daily priced Private Real Estate vehicles available today
- Increased market transparency
- Improved risk & liquidity management

The Next Phase of Hedge Fund Evolution

- Hedge funds have been around for decades, but only recently made widely available

<table>
<thead>
<tr>
<th>Phase</th>
<th>Institutional Use</th>
<th>Individual Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusively high net worth</td>
<td>Private equity, other institutions</td>
<td>DC plans, retail investors</td>
</tr>
<tr>
<td>Availability to retail investors</td>
<td>Dividend, interest income</td>
<td>Liquidity focus, mainstream access</td>
</tr>
</tbody>
</table>
Why Bother?

- Return and asset diversification
- Downside protection
- Enhanced return potential
- Volatility reduction
- Manager flexibility
- Top industry talent
- Favorable environment going forward

Final Thoughts on QDIA Due Diligence – Managed Accounts

- Confirm process and philosophy
- Monitor outcomes
- Carefully negotiate costs
- Review participant materials

Takeaways and Trends

- The market has spoken; Target-Date Funds are the winner
- Consider the retirement objectives and characteristics of your workforce, don’t just consume the market
- All glide paths are not created equally; consider the risks associated with “to” and “through” glide paths
- Broader asset diversification can create better outcomes
- No one management style is always the “best”; consider how active and passive styles work together
Questions