Asset Allocation Techniques during the Accumulation Phase

Panelists:

- Christopher Hamilton, Invesco
- Jeremy Stempien, QMA, Prudential
- Bridget Witzeman, Voya Financial

Moderator: Tom Anichini, GuidedChoice

1

What we will cover today

- **Introduction to panel and why this topic matters**
- **How lineup construction can assist with asset allocation decisions**
- **Types of asset allocation**
- **Asset allocation solutions**
- **Establishing, evaluating, and measuring asset allocation solutions**
- **Key takeaways**

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2

Introduction: panelists and moderator

Panelists

Christopher W. Hamilton, CFA, CAIA
Head of Portfolio Advisory, Invesco

Jeremy Stempien
Principal, Portfolio Manager & Strategist, QMA, Prudential

Bridget Witzeman
Vice President, Advisory Services, Voya Financial

Moderator

Thomas M. Anichini, CFA
Chief Investment Strategist, GuidedChoice

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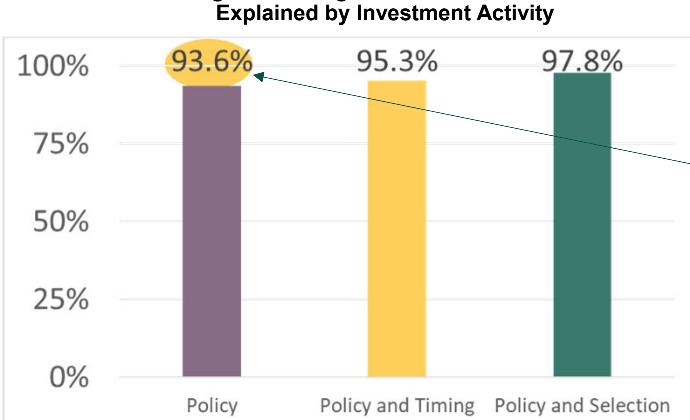
Introduction: Why this topic matters

Average Percentage of Total Return Variation Explained by Investment Activity



Asset allocation (policy) explains most of the return variability of portfolios' performance

Source: Determinants of Portfolio Performance II: An Update, *Financial Analysts Journal* (May~June1991), pp. 40 - 48. Table VII

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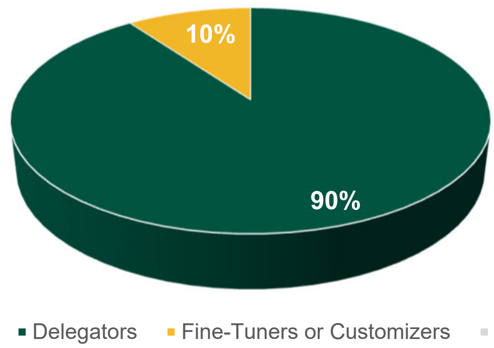
4

How pre-packaged asset allocation solutions fit into a plan menu



Source: Shlomo Benartzi with Roger Lewin, *Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans* (London: Penguin: 2012) p.187

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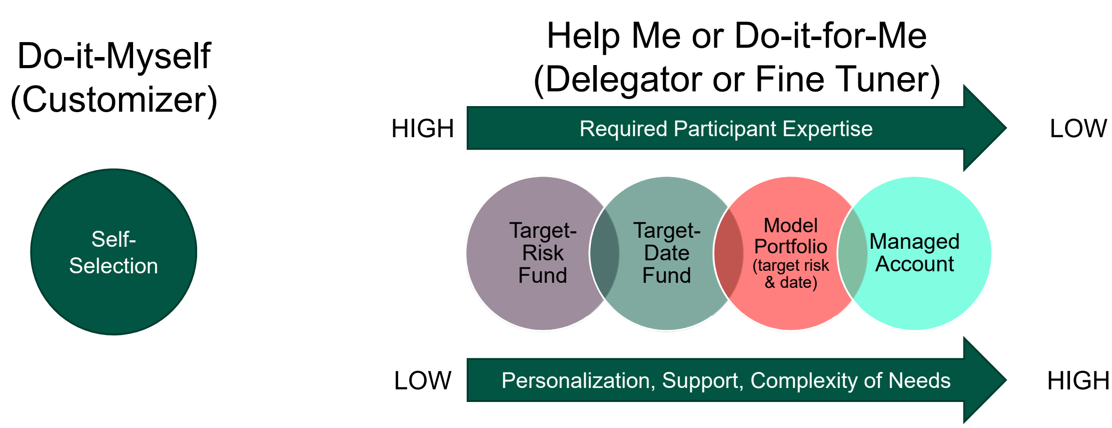
Why the topic matters – behavioral finance



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How lineup construction can assist with asset allocation decisions

What's available for core lineups

Additional investment options available for asset allocation solutions

Evaluating plan menus

Balancing robustness with keeping complexity manageable

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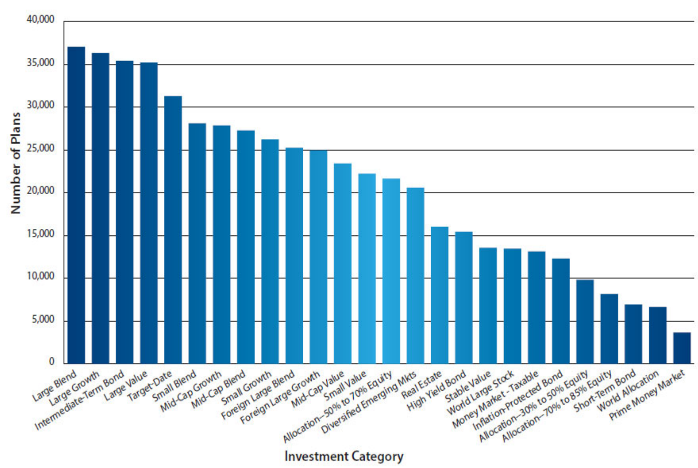
What's available for core lineups



ERISApedia.com: 401(k) Portfolio Study of Investment Categories, January 2019

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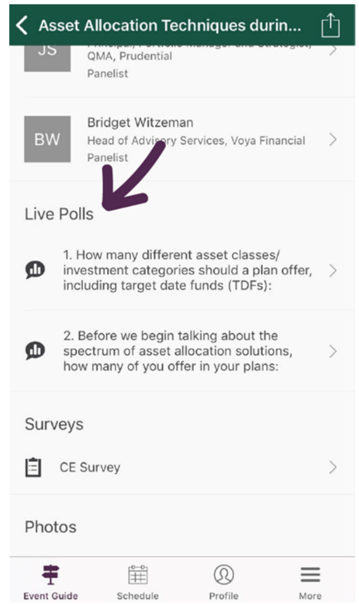

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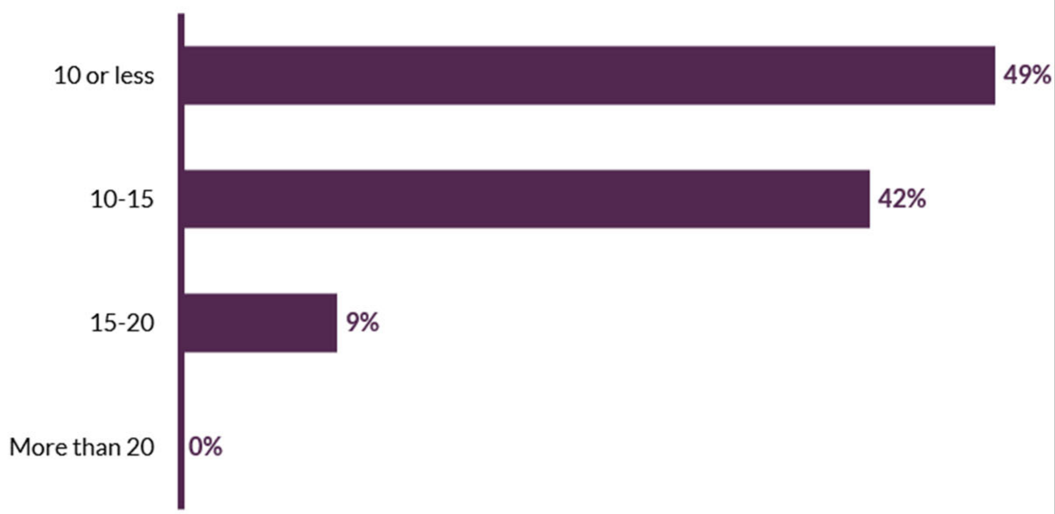
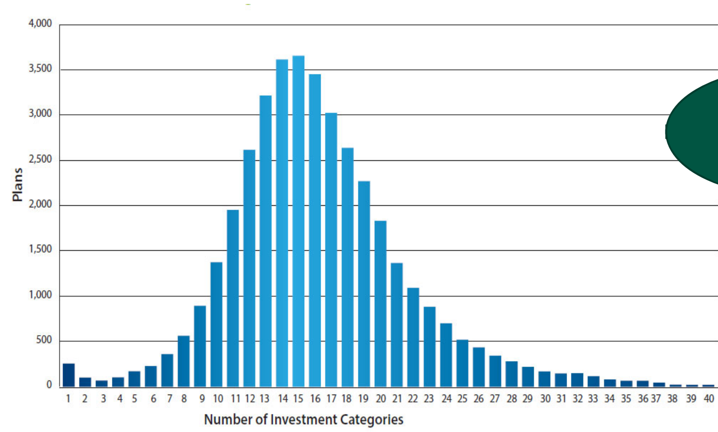
1. How many different asset classes/investment categories should a plan offer, including target date funds (TDFs):



Source: https://api.cvent.com/polling/v1/api/polls/spnmq96k

10

Average number of asset classes available



Average of 16.2

ERISApedia.com: 401(k) Portfolio Study of Investment Categories, January 2019

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11

Additional investment options available for asset allocation solutions

Inflation Sensitive

- TIPS
- Real Estate
- Global REITS
- Commodities
- Real Assets

Diversifiers

- Bank Loans
- GTAA
- Preferred Stock
- Hedge Funds
- U.S. Balanced

Income Generation

- In-plan Annuities
- Absolute Return Fixed Income
- Long duration bonds fund

Environmental, Social and Governance (ESG)

- Single focus
- Blended Focus

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12

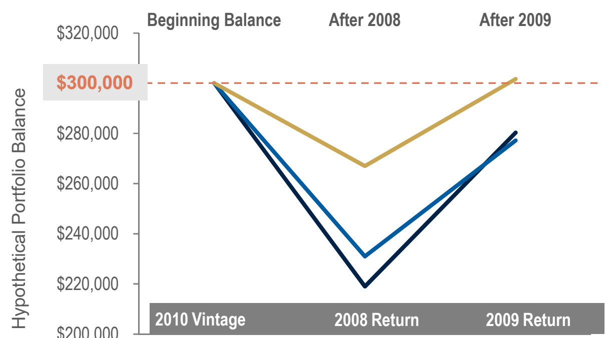
Non-traditional asset classes can lead to better preservation of capital

83%

of participants near retirement indicated that they are willing to give up returns on the upside, in order to protect on the downside[1]

CASE STUDY: 2008-2009 NEAR-RETIREMENT

Hypothetical Portfolio Balances of 2010 Vintages



2010 Vintage	2008 Return	2009 Return
TDF A	-11%	13%
TDF B	-23%	20%
TDF C	-27%	28%

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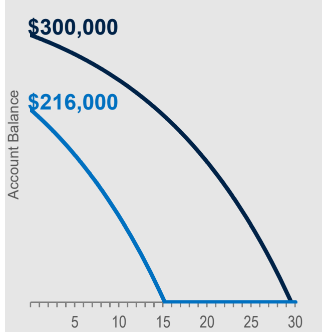
Source: Morningstar, Inc.; Assuming No Cash Flows. For illustrative purposes only. Data represents past performance and is no guarantee of future results. [1] 401(k) Specialist, "401(k) Participants Want Investment Protection Over Growth," 6/28/17; Cerulli research shows 83% of TDF participants age 60 to 69 and 86% of those 70 and older support their TDF managers protecting their portfolios from market losses, even if that means the TDF underperforms in certain market environments.

13

Non-traditional asset classes can lead to better preservation of capital

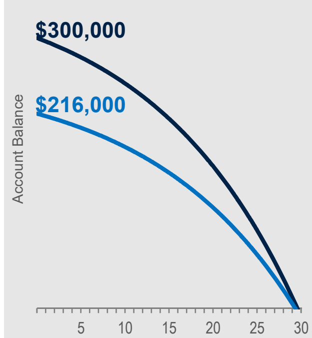
RUN OUT OF MONEY SOONER

1. Maintain lifestyle with $1,800 monthly income, but run out of savings early



LIVE ON LESS

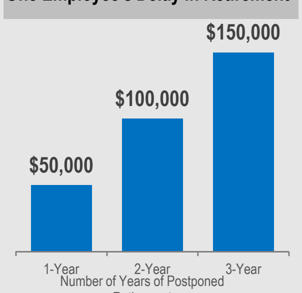
2. Reduce lifestyle with $500 less in monthly income to make savings last 30 years



WORK LONGER

3. Undesirable for the participant, and comes at a cost to the employer

Employer Costs Incurred Due to One Employee's Delay in Retirement[1]



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Source: PGIM. This investment scenario is for illustrative purposes only. A participant set to retire with a balance of $300,000 may expect to receive $1,800 per month ($21,600 annually) assuming 6% annual return for 30 years after retirement. Should the participant experience a drawdown of 28% (the average 2010 TDF return during the Financial Crisis, Source: Morningstar 10/9/07–3/9/09), the beginning balance would decline to $216,000. [1] Source: "Why Employers Should Care About the Cost of Delayed Retirements," Prudential Financial 2017.

14

Evaluating plan menus

- Plan diversification should be the top priority of participants.
- Historically, advisors suggested a 60/40 equity to fixed income allocation
- Most now agree investors should consider increased diversification for the reasons below[1]:
  - Increasing longevity shifts the focus to growth.
  - Option 1: Diversification is critical for long term investing
  - Option 2: Traditional 60/40 asset mix limits diversification
  - The market is evolving.
  - Investors' needs aren't static.

1. https://money.usnews.com/investing/investing-101/articles/why-the-60-40-portfolio-is-dead-for-retirement-planning

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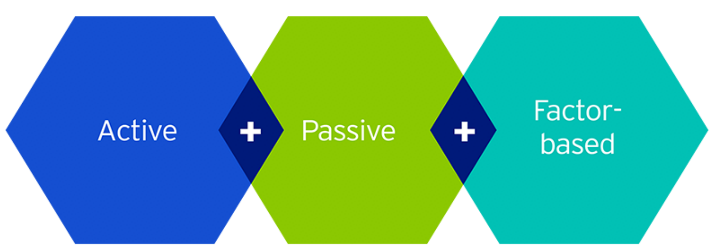
Balancing robustness with keeping complexity manageable

- Strategic allocations should be broadly diversified to meet client long-term investment objectives.
- Rather than solely focusing on traditional asset classes, allocations may also include alternatives to enhance diversification
- Diversification may also be improved, by blending active, passive and factor-based strategies.
- Factors are characteristics of securities such as value and quality that may help enhance returns.



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16

Types of asset allocation

Strategic and Tactical Asset Allocation

Glidepaths

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17

Types of asset allocation

	Strategic Asset Allocation	Tactical Asset Allocation
Time Horizon	Long-term (ex: 10 years – indefinite)	Short-term (ex: days, weeks, months)
Policy Driver	Focus on long-term expectations with low emphasis on current market conditions	Focus strongly on current market conditions
Beliefs	Beta drivers and mean reversion	Alpha drivers with an ability to add incremental return through predicted shifts in market fundamentals
Opportunities	Long-term consistent relative performance	Market timing adds ability to add alpha (up/down markets)
Risks	Missing short-term alpha opportunities	Adversely adjusting risk characteristics at inopportune times

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Source: QMA.
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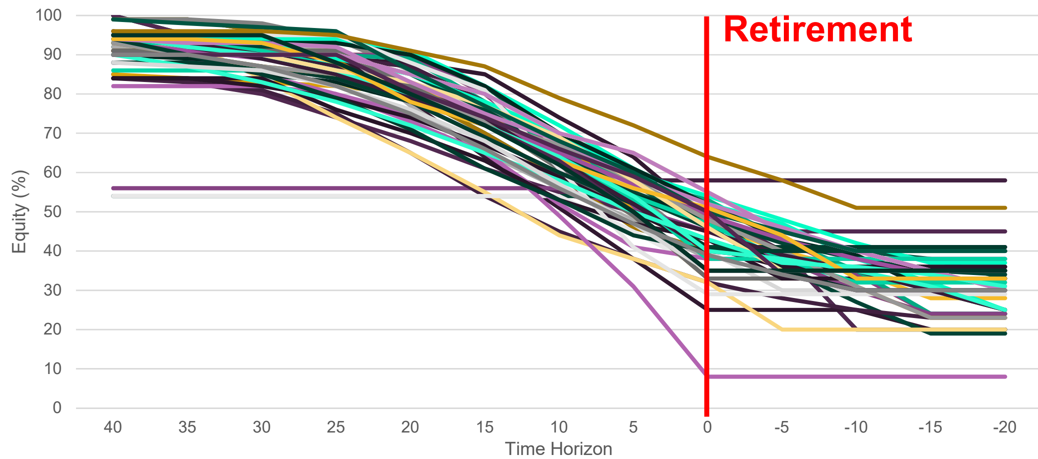
18

Target date glidepaths: addressing key risks



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Source: Morningstar, QMA.
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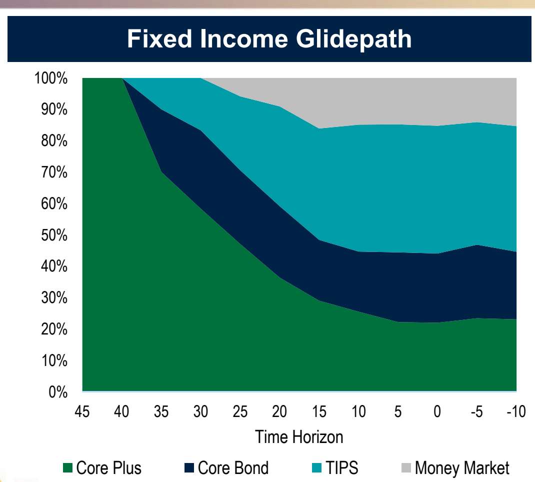
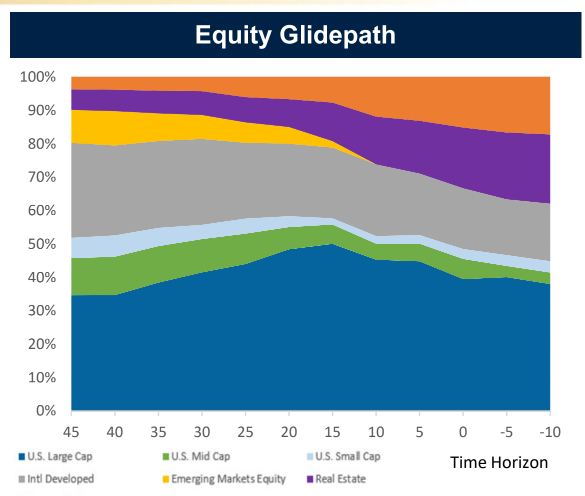
19

Asset allocation glidepaths within the glidepath





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Source: Morningstar, QMA.
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20

Spectrum of asset allocation solutions

Model portfolios, target date funds (TDFs) and asset allocation services

Managed account providers and robo-advisors

Personalization

Blended solutions

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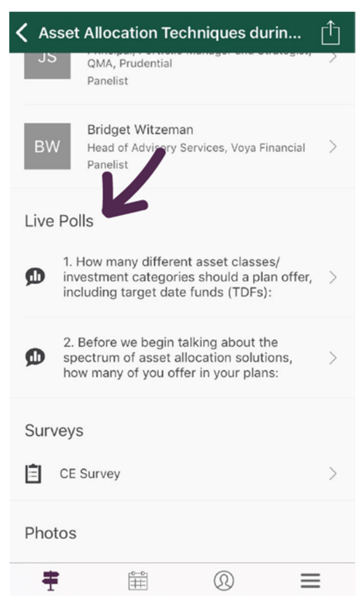

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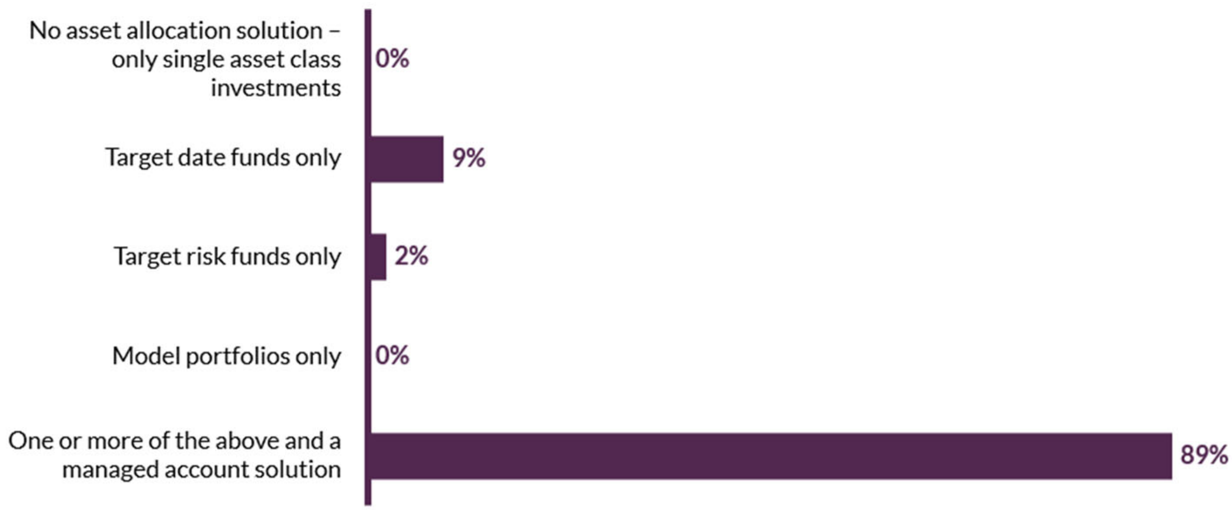
2. Before we begin talking about the spectrum of asset allocation solutions, how many of you offer in your plans:

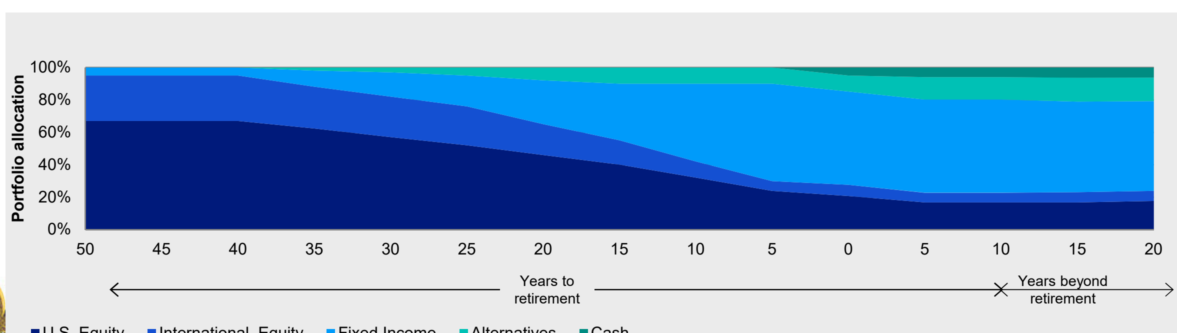


Source: https://api.cvent.com/polling/v1/api/polls/spc7k8dc

23

Model portfolios, TDFs and asset allocation services

- We take a unique hybrid approach to our strategic allocation which:
  - Blends active, passive, and factor-based investing
  - Thoughtful and balanced approach to risk and return
  - Strategic alternative exposures, increasing diversification potential
  - Designed to minimize risk in periods of high market volatility
  - Engineered to carry investor through their retirement data



24

Managed account providers and robo-advisors

	Robo Advisor	Managed Account
Automatic rebalancing	✓	✓
Digital tools	✓	✓
Personalization – sponsor provided data (including DB provided data)		✓
Participant customization	Often limited	✓
Integration with Plan web site		✓
Drawdown planning and execution		✓
Phone or in person support		✓
Financial planning		✓

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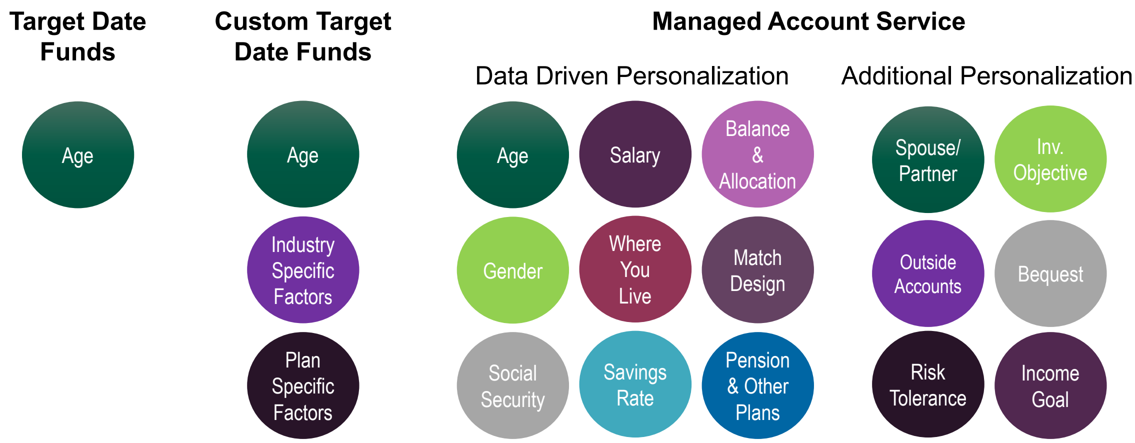
25

Personalization



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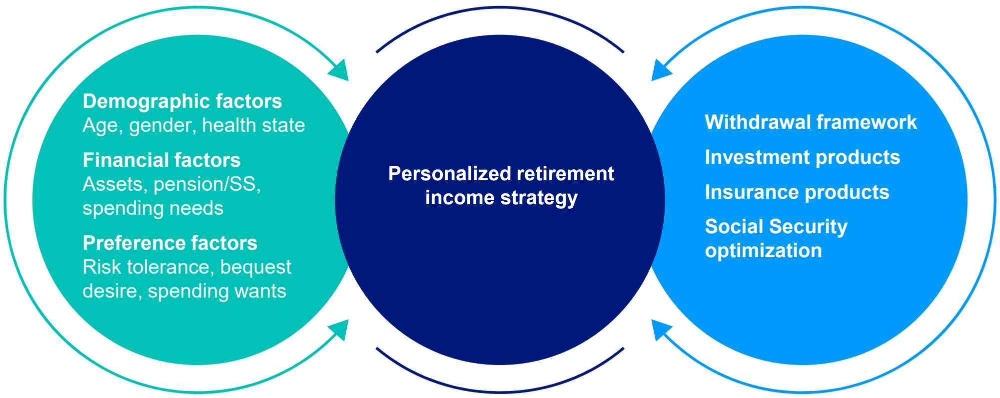
26

Retirement income

Many factors affect decumulation, making the creation of a one-size-fits-all approach much less effective



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27

Establishing, measuring and evaluating an asset allocation solution

How effective is the solution in achieving its goal?

Sensitivity to the plan's defined benefit plan, if any

What is an appropriate fee structure based on value of the solution?

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28

Defining the goal and measuring success toward achieving it

- Think about establishing objectives for different ages, or areas of a glidepath, including market value protection near retirement.
- Propose specific metrics and incorporating them in plan IPS.

Performance Evaluation Metrics

Younger Investors	Investors Near Retirement	Retirees
• Long-term peer-relative results • Standard deviation • Sharpe ratio • Performance vs. custom Bench	• Peer-relative results in time periods in which the market has declined by 10% or more • Standard deviation • Sharpe ratio • Max drawdown • Down-market capture ratio • Performance vs. custom Bench	• Fund net returns vs CPI • Peer-relative results in time periods in which the market has declined by 10% or more • Standard deviation • Sharpe ratio • Max drawdown • Down-market capture ratio • Performance vs. custom Bench

Source: QMA.
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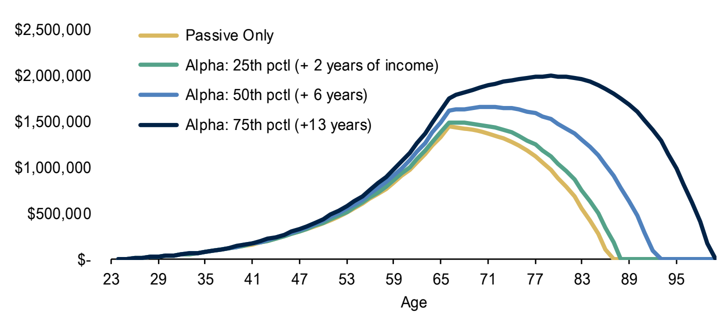
29

Ultimate goal is to help participants retire securely

- "Alpha" can dramatically impact retirement outcomes.
- Just 35 basis points of additional return annually over a lifetime of savings and spending can provide an additional six years in retirement.

Effects of Alpha on Retirement Income



Total retirement savings over an individual's lifetime. Participant assumptions: initial age of 23, initial salary of $40,000 with 3% annual salary growth, 10% savings rate, and withdrawal rate of 71% of final salary with subsequent 3% annual cost-of-living adjustments beginning at age 66. Investment assumptions (arithmetic): annual portfolio return of 7%, passive investment fee of 0.10%, active investment fee of 0.60%, and 1.0% gross of fee alpha assumption with a tracking error of 3% normally distributed. Alpha percentiles net of fees (geometric): 0.03% at 25th percentile, 0.35% at 50th percentile, and 0.68% at 75th percentile.

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Polling question

Before we begin talking about the impact of Pension Plans on Asset Allocation solutions, how many of you offer a DB plan:

1. Yes, and available to all employees
2. Yes, but there are different formulas for different employee groups
3. Yes, but frozen and not available to new employees
4. No

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Sensitivity to the plan's defined benefit plan

- Does the solution's allocation take into consideration the relative size of any defined benefit and, if so, to to what degree?
- Does it treat a cash balance pension in the same way it does a traditional pension?
- Can your defined benefit plan be automatically integrated for consideration in the solution?

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What is an appropriate fee structure based on value of the solution?

No "one-size-fits-all" approach to pricing. Pricing schedules are generally negotiable and depend on many variables

- Complexity of solution
- Competitiveness in the market place
- Vehicle type
- Desired exposures
- Hedging and use of derivatives
- The average annual net expense ratio for target date plans is around 0.54%; average management fees fall around 0.21% per the Morningstar 50%-70% equity target date allocation category [1]
- In fund-of-fund structures, average acquired fund expenses are 0.41% [1]

1 Source: Invesco Product & Market Research Group. Data as of May 31, 2019

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Conclusions: Key Takeaways

Asset allocation is an essential decision for DC participants

Most appropriate allocation varies by time horizon and personal details

Viable solutions abound, including blended solutions, no need for DIY asset allocation

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Conclusions and Questions

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36