Strengthening the core

Preparing DC menus for the next evolution

DEFINED CONTRIBUTION

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EXECUTIVE SUMMARY

Generally strong equity and bond returns in the decades since the 401(k) entered the tax code have shaped defined contribution (DC) menus.

In our experience, the average menu has a core bond fund and multiple equity selections spread across style boxes and regions.

Our examination of how participant assets are invested suggests that the selection of funds is providing less diversification than many plan sponsors may suspect.

In addition, industry consensus expectations for reduced returns over the next decade or more further challenge today's menus.

We believe the next evolution of investment menus needs to be driven through four steps:

1. Consider supplementing low cost, broad index positions with additional sources of diversification and return with white label, factor and rules-based smart beta strategies

2. Expand the fixed income opportunity set to target the potential for stronger returns and income

3. Reexamine the target date fund as part of the full menu review

4. Unlock and realign legacy default assets through reenrollment

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Defined contribution core menus are a product of their times – and for most of the 401(k) era, times were good.

We define the 401(k) era as the almost four decades since the 401(k) entered the tax code in 1978 that set the foundation for the defined contribution system. It has been a period during which declining interest rates fueled a bond bull market and, despite considerable volatility and notable bear markets, average annual returns for stocks were strong.

It's not surprising that the prevailing investment environment shaped the size and selections offered in the typical core menus.

In our experience working with plan sponsors we have found, for example, that robust returns for funds based on the Barclays Aggregate U.S. Bond Index ("Agg") meant that most felt little need to offer other fixed income options.

By contrast, the increased growth, segmentation and globalization of the equity market led to a proliferation of fund choices across style boxes, regions and strategies.

More recently, a growing recognition — driven in part by behavioral finance — that investment menus need to do more than provide choice forced an evolution in plan design. We believe investment menus now need to encourage choices that help drive saving and diversification. Today's plan design typically uses a tiered investment menu, with a qualified default investment alternative (QDIA) — most often a target date fund (TDF) — and a streamlined selection of allocation building blocks, with a few specialty funds rounding out the lower tiers.

Yet today's best practices are under pressure on a number of fronts. Baby boomers are now in or near retirement and face very different risks than they did when their focus was on accumulating assets. As we will show, when we examine how participants are actually invested across today's menus, we often find that the QDIA is frequently underutilized and diversifying options are often less effective than they appear. More critically, there is a significant consensus that we are entering an extended period where returns will be harder to come by, challenging both the ability to accumulate assets and the management of longevity risk. (See, for example, *Horizon Actuarial 2016 Survey.*)

These pressures call into question the adequacy of today's core menus and should spark a discussion regarding how menus can evolve to help participants build for retirement. That discussion should begin by examining where participants are putting their money.

Follow the money: Are investment menus doing the job?

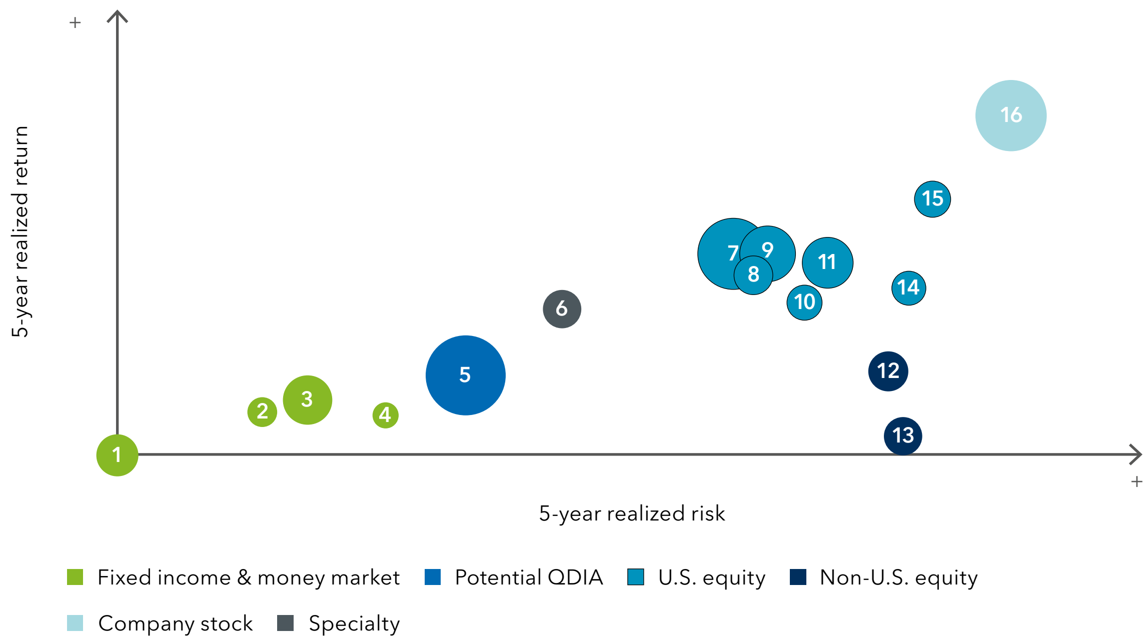
Investment menus are designed to provide choice and diversification. How well are they accomplishing those tasks? BlackRock's Spotlight analytics use plan data to create a snapshot of how participants are allocated across a plan's investment menu. The results are frequently surprising.

DC plan menu #1

As illustrated in DC Plan Menu #1, each color-coded bubble represents a menu option. The size of the bubble is proportional to the assets invested in that fund. The circles are further plotted against the X-axis, measuring 5-year standard deviation (realized risk), and the Y-axis, measuring 5-year realized return. The allocation snapshots in this paper use actual plan information and risk and return data sourced by BlackRock. The charts shown here should not be considered representative of DC plans as a whole, but have been selected to highlight specific core menu issues.

At first glance, this seems like a well-diversified menu with a wide spectrum of choices. On closer examination, however, potential issues emerge. For instance, the QDIA (#5) is the largest holding – but not by much, suggesting that the QDIA may be underutilized. The second and third largest holdings are an S&P 500 Index fund (#7) and a company stock fund (#16). While the S&P 500 is a diversified large cap fund, its risk exposure suggests it may not be appropriate as the sole holding for many participants, especially those close to retirement. A glance at the chart shows that company stock is an outlier for both risk and return.

A wholesale trade business with a potentially underutilized QDIA



Example for illustrative purposes only. Charts have been selected to illustrate specific issues found in core menus and should not be considered representative. Source: BlackRock Spotlight analysis. If the potential QDIA is a TDF, the bubble combined the assets of all TDF vintages and return and risk of the TDF series is represented by the vintage fund most appropriate for someone retiring today.

Additional considerations

Significantly greater risk

Considering the menu overall, the size of the U.S. equity, non-U.S. equity and company stock allocations suggests that participants are exposed to significantly greater risk than they would be if they were invested in the QDIA. If the consensus forecast is correct, and future realized returns are lower while volatility remains close to current levels, participants may not be sufficiently rewarded for carrying the additional risk.

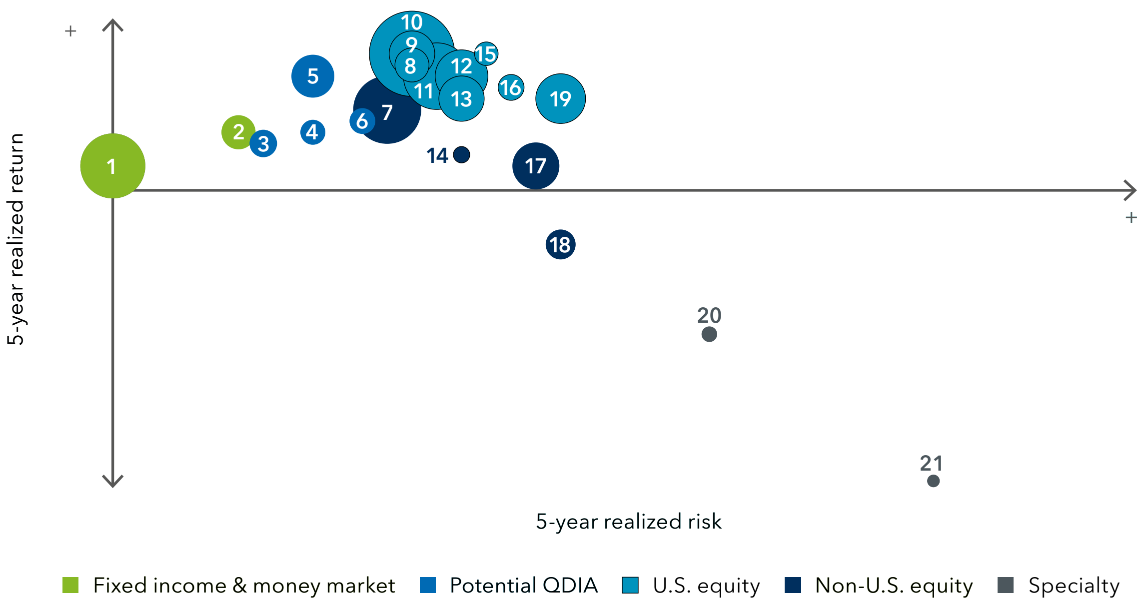
Diversification in name only

There is significant overlap in the risk/return profiles for five of the equity funds (#7 – 11). Three of the funds (#7, #8 and #9) overlap nearly completely, meaning that they have nearly identical risk and return profiles. Funds #10 and #11 are immediately adjacent, which calls into question whether the five funds offer meaningful diversification.

DC plan menu #2

The question of diversification is also raised by DC Plan Menu #2. The plan offers nine domestic equity funds, eight of which are clustered together, with five nearly entirely overlapping. By contrast, there are only two fixed income funds. This concentration of equity profiles suggests that picking equity funds to target style box diversification may offer less choice in practice than in theory.

A professional services company with many choices but little diversification



Example for illustrative purposes only. Charts have been selected to illustrate specific issues found in core menus and should not be considered representative. Source: BlackRock Spotlight analysis. If the potential QDIA is a TDF, the bubble combined the assets of all TDF vintages and return and risk of the TDF series is represented by the vintage fund most appropriate for someone retiring today.

Additional considerations

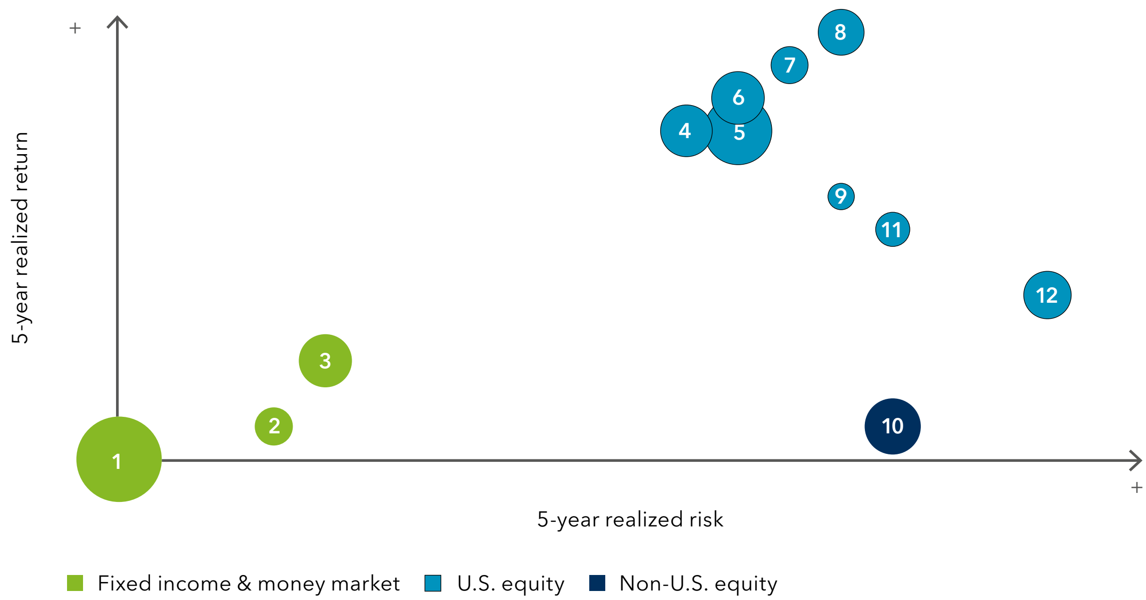
Participant overload
The sheer number of equity funds forces participants to discern the differences among them, something many may be unable to do. There is a similar concern regarding the QDIA. This plan offers a choice of balanced funds for conservative, moderate, etc., investors. While this seems straightforward, it assumes that participants know their risk tolerances and understand the differences between their choices in a meaningful way.

Insufficient fixed income options
During the long-term U.S. bond bull market, there may have been little reason to offer bond funds not pegged to the Agg. Today, we believe the potential return opportunity may lie outside of strategies that strictly adhere to the Agg, and participants, particularly those near or in retirement, may benefit from a wider range of choices for managing retirement income.

DC plan menu #3

In the final plan snapshot, DC Plan Menu #3, the domestic equity selection seems diverse. There is, however, no QDIA or managed account option. The plan sponsor may have assumed that a carefully considered equity menu could best serve its participants. But without a multi-asset solution, the plan sponsor is banking on participants' ability to diversify their portfolios and rebalance them over time – something they are not likely to do as well as professional managers. Perhaps predictably, many participants may have felt unable to make an informed selection among the equity funds and retreated to the capital preservation option.

An entertainment and recreation company without a professionally managed multi-asset solution



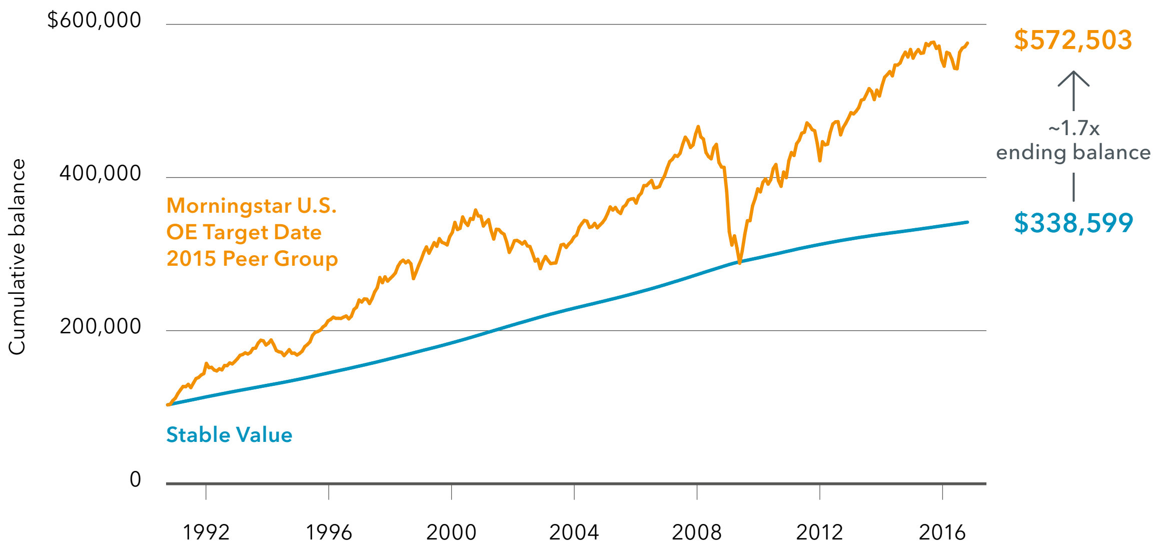
Example for illustrative purposes only. Charts have been selected to illustrate specific issues found in core menus and should not be considered representative. Source: BlackRock Spotlight analysis.

Additional considerations

Opportunity cost

Capital preservation options are not designed to provide an optimized, age-appropriate risk exposure to help build assets and manage longevity risk. The *Opportunity Cost* graph below illustrates this by comparing the return for the Morningstar Target Date Mutual Fund 2015 Peer Group against a stable value option. Even though the time period includes the severe market downturn associated with the financial crisis, the ending balance for the target date fund composite is substantially higher.

Opportunity cost of investing in a capital preservation option



Source: Morningstar Direct as of 6/30/2016. The graph above displays the growth of $100,000 over a 25.75-year period, utilizing historical monthly returns, assuming an initial investment date of 9/30/1990. The blue line represents the plan's largest capital preservation option with sufficient data. The orange line represents the Morningstar Target Date Mutual Fund 2015 Peer Group, the peer group for vintages closest to the target date for a participant retiring today. The Morningstar Target Date Mutual Fund 2015 Peer Group is shown to demonstrate the cumulative impact of taking risk consistent with a diversified investment strategy as compared to a capital preservation investment strategy. Prior to the adoption of the Pension Protection Act, capital preservation funds were often the default investment option, while today, it is common for a plan sponsor to choose a target date fund series as the QDIA. For illustrative purposes only. Past performance is not a guarantee of future results. Indexes are unmanaged and not indicative of any fund's performance. It is not possible to invest directly in an index.

The next evolution of investment menus: Four steps to consider

Where to go from here? The first step is to review the plan to understand where the assets are held and which funds are getting the lion's share of flows. We believe that there are four key focus areas for strengthening the investment menu.

Step 1: Consider additional diversification and return

Do today's investment menus offer genuinely diversified equity options beyond the QDIA? Specifically, can participants construct a portfolio that offers differentiated sources of risk and return? Our review of the three sample menus suggests that many plans simply check off the style boxes but may not deliver genuine diversification. There are two ways the core menu can help address diversification, one structural and the other through implementation.

Diversification within a streamlined menu

White label funds

Diversification may be achieved through a multi-strategy, white label option. Rather than offering a range of equity funds and expecting participants to select and maintain a mix, the plan could offer a streamlined equity menu option with a stated goal of delivering above benchmark returns. White label funds might include smart beta or factor strategies, as well as cap-weighted index and active strategies.

The fund manager or the plan sponsor can then shift the allocation within the white label fund as markets and economic cycles evolve in order to seek to manage risk and capture returns. This approach would relieve participants of the task of forecasting and responding to changing market environments, with the goal of a more professional allocation of assets across the core menu and, ideally, more consistent return streams.

Differentiating sources of risk and return

Lower cost, broad-based index strategies are likely to remain a foundation of investment menus. There are, however, strategies that have the potential to augment returns or help improve risk management that range from index-based approaches to more complex strategies.

Smart beta strategies

Factors are not new; for decades, academics and active managers have understood that certain economic and style factors have been persistent drivers of return. Today, data and technology that make it easier to identify and act on factor insights are broadly available.

Smart beta can be described as a long-only, index-based factor strategy. A smart beta portfolio can be designed to maximize exposure to certain combinations of factors and constrain exposure to others in order to help meet certain objectives. For example:

- Plan sponsors seeking to potentially outperform the cap-weighted index with similar risk exposure may consider an approach based on the MSCI Diversified Multi-Factor Index, which tilts the index toward value, momentum, quality and size factors.

- Alternatively, plan sponsors seeking a similar level of return to a cap-weighted index may wish to consider minimum volatility strategies that seek to constrain exposure to portfolio volatility while retaining exposure to potential return-driving factors.

Smart beta strategies can help keep a plan sponsor comfortably within a rules-based index approach while taking advantage of academic research and institutional investing strategies.

Other factor strategies

Other strategies, such as risk parity or style factor rotations, can be more complex and may include long/short positions intended to isolate security selection as a source of return. For core menu purposes, these sophisticated factor strategies may provide diversification based on deep insights into return drivers and may be more appropriate in white label (or multi-factor) funds or customized target date structures.

Step 2: Expand the fixed income opportunity set

During the era of strong bond fund returns, there was little reason to offer bond funds not pegged to the Agg. Today, the aging baby boomer population has been moving into retirement and is seeking sources of both retirement income and reduced risk exposure. Unfortunately, many older participants, conditioned by the bond market boom, may have unrealistic expectations about what bond funds could provide.

Plan sponsors may want to consider introducing increased flexibility and choice, both within core options and in the number of options by:

Expanding the opportunity set

From a core menu diversification perspective, strict reliance on the Agg means a concentration of interest rate risk that leaves much of the fixed income universe off-limits.

For example, a Total Return strategy remains anchored in the traditional, high-quality fixed income world, yet selectively expands the opportunity set to potentially include high yield, emerging markets debt and other sectors to seek additional return and limit concentrated positions.

Incorporating a factor-based allocation

Plan sponsors may also wish to consider incorporating factor-based strategies into their core fixed income funds by seeking to manage the macro-economic exposures within their strategy. For example, a Fixed Income Balanced Risk (FIBR) approach seeks to maintain equal exposure to perhaps the two primary economic factors driving fixed income returns: interest rates and credit. The allocation decision between interest rate and credit exposure may have a larger impact on the investment outcome than security-specific decisions.

Rethinking how to provide income

A case can be made that the complexity of the fixed income universe, the potential low return world and the growing need for retirement income vehicles for retirees requires a wider range of fixed income options. Possible additional strategies may include high yield, global, credit, multi-sector and unconstrained, as well as strategies that combine preferred stock, dividend stock or other financial instruments designed to generate income. As with equities, we believe many participants would benefit from the simplicity of a white label option combining a variety of fixed income and income-generating strategies.

Step 3: Review the target date fund

A target date fund is not only the foundation of the investment menu, but it also, in large part, determines the needs that supplemental or complementary menu options are designed to meet. Unfortunately, many target date funds were established when return expectations were much higher than today's consensus expectations. Therefore, we believe part of any investment menu review should include a reexamination of the target date fund and its potential to generate returns and manage volatility.

A target date fund check list might include:

Exposure to growth assets
We believe that the glidepath needs to capture maximum growth early in a participant's career to generate the returns that may be necessary to sustain retirement spending. In addition, we believe the equity allocation at and through retirement needs to provide adequate growth for a retirement that may last for decades.

Sources of additional return
If return expectations are lower, plan sponsors may need to reconsider whether index exposure is enough to help meet participant needs. Cost-effective strategies intended to partially offset lower expected beta may include smart beta indexes, factor strategies and tactical glidepath adjustments. In addition, plan sponsors should consider reviewing exposure to international small caps, emerging markets and real assets, such as commodities and real estate.

Addressing volatility
While return expectations are lower, volatility is expected to remain consistent with recent experience. This may exacerbate a persistent behavioral finance issue: participants overreacting to market volatility and retreating to the sidelines. With reduced expectations, it is critically important that they remain invested to seek to capture market returns as well as participate in potential rebounds — and that places new importance on managing volatility.

Clarifying fixed income's role

It is important to be clear about the role of fixed income within the target date fund – whether it is a source of return, diversification, risk management or income – and make necessary adjustments. Plan sponsors may consider looking beyond the opportunity set captured in the Agg and/or adjusting the mix of interest rate and credit risk in the bond allocation.

Exploring expanded investment instruments

Despite having similar objectives, DC plans do not use the full range of tools and instruments commonly found in defined benefit (DB) plans. In addition to smart beta and factor strategies mentioned earlier, many DB plans also invest in alternatives and less liquid securities, such as private equity. While operational difficulties would need to be addressed, these and other similar instruments have the potential to generate long-term returns and help manage volatility.

Keep in mind that QDIAs are subject to ERISA regulations and that certain thresholds need to be met; any adjustments need to conform to ERISA thresholds and requirements. Ultimately, however, adjustments to the QDIA will fail to meet the plan's objectives if participants do not use the QDIA or do not defer a sufficient portion of their salary.

Step 4: Unlock legacy assets

The 10th anniversary of the Pension Protection Act ("PPA") in 2016 sparked conversation about new regulatory guidance that may be needed to help drive the evolution of DC plans. We believe that tapping the full potential of PPA provisions would be a helpful start in addressing many core menu and DC plan challenges.

As long as certain conditions are met, the PPA offers plan sponsors safe harbor protection to enroll participants in an appropriately diversified solution. Reenrollment would reset core menus to capture today's best practices, potentially unwinding issues created by legacy funds, ineffective plan design and participant inertia. What's more, it would simplify the challenge of helping manage participants through a potential low return environment.

The arguments for reenrollment are generally well known. And increasingly, plan sponsors are taking the step; according to the *Callan Associates 2017 Defined Contribution Trends* survey, one in four plan sponsors said they had engaged in a reenrollment, up from 1 in 10 two years ago. One of the reasons many plan sponsors do not take the step is that they feel they are on uncertain fiduciary ground. However, in an article published by BlackRock, Julie Stapel, a partner in the Employee Benefits practice group of law firm Morgan, Lewis & Bockius LLP, suggested that reenrollment can help improve fiduciary risk management. What's more, she stated:

> "*When the Department of Labor issued the QDIA regulations, the DOL commentary that came along with the regulations made it clear that the QDIA was applicable beyond just the auto-enrollment context. The DOL simply said that, whenever a participant has the opportunity to direct his or her own investments but does not, a plan sponsor may default those amounts in the QDIA and receive protection from fiduciary liability in doing so.*"

While plan sponsors should seek their own legal guidance, Stapel's suggestion is that the same protections afforded to plan sponsors using automatic enrollment into a QDIA could also apply to reenrollment into a QDIA, as long as the participant has the opportunity to opt out.

Without reenrollment, many plan sponsors accept that only a portion of their participant population – those who joined at some specified date after the selection of a QDIA – gets the benefit of the QDIA and many other plan features, such as auto-escalation. The rest of the workforce is left to opt into the QDIA on its own or worse, look for answers regarding appropriate allocation and contribution rates.

Cash options and retired participants

There are two additional considerations that may not fit neatly into the four steps listed previously but may help align plans and core menus with today's investing and demographic realities.

Cash and low-risk options

As we suggested in the *Opportunity Cost* graph on page 10, there may be an opportunity cost to remaining in money market or stable value strategies for a long period of time. Nonetheless, in some circumstances, participants want a short-term position. Plan sponsors may need to consider how well the traditional cash options serve participant needs.

Certainly, recent regulations governing money market mutual funds have complicated the picture. At the risk of oversimplifying, certain prime money market mutual funds are required to have a floating NAV and may be subject to redemption fees or a delay in redemptions. Many plan sponsors have responded by moving to a government money market mutual fund that is exempt from many of the new requirements.

A short-duration bond strategy, however, has the potential for increased total return (compared to a money market fund option) in exchange for some volatility of principal. Participants may be willing to accept some short-term principal volatility exposure in exchange for a better return. If the participant, however, seeks stability of principal, then a money market or stable value option makes sense.

Allowing retired participants to draw income

The potential benefits of participants remaining in the plan after they retire are clear: if a plan sponsor encourages participants to remain, they may be able to help facilitate an income distribution. In addition, all participants may benefit from potential economies of scale if the plan retains retirement assets. In order to accomplish this, however, plan sponsors may need to review their policies and work with their recordkeepers to create a mechanism for periodic distributions as well as consider how to guide participants regarding the option of remaining in the plan throughout retirement.

Bringing it all together

The basic structure of DC menus will likely remain similar to the best practices we know today. That means we should continue to see a QDIA, most likely a target date fund, designed to deliver age-appropriate diversification. Next would be a simplified tier of stock and fixed income portfolio building blocks, ideally offering greater diversification than current options.

This tier may be intended either to provide asset allocation building blocks or to achieve targeted outcomes. For example, a building-block approach might include broad-based large cap, emerging markets and/or global stock funds within a single white labeled equity option. Outcome-oriented menus might label various funds as growth or capital preservation, and so on. Finally, there would be funds designed to meet specialized needs or help more sophisticated participants manage specific risks, gain targeted exposure or generate retirement income.

We are more likely to see evolution within the strategies themselves or with the selection of building block options. Ultimately, each plan will differ based on the plan sponsor's needs, beliefs and preferences. Plan sponsors may want to consider reenrollment into the QDIA or mapping equity and fixed income assets into white label core exposures to give them greater ability to help manage the changing market environments, seek diversification and reduce concentrated risk on behalf of their participants while simplifying the menu.

The *Guide to Investment Menu Evolution* below offers suggestions and key considerations for resetting menus to help drive more secure retirement outcomes in a new era.

Guide to investment menu evolution

	Considerations
Equities	• Can equity options be streamlined to eliminate overlap and duplication and to better diversify return streams? • Can a multi-strategy white label structure be used to give the plan sponsor greater control over diversification and risk management?
Fixed income	• Do standalone fixed income options balance exposure to interest rate and credit risk? • Can income needs be managed through a multi-asset option including a broad range of bonds, preferred stock and income producing instruments? • Are additional fixed income options needed to offer participants more diversification in an increasingly complex fixed income environment? • Would a short-duration bond fund provide attractive return in exchange for modest principal volatility?
Target date fund	• Does exposure to growth assets need to be reconsidered in light of reduced return expectations? • Should the TDF be expanded to incorporate other strategies, such as smart beta, and additional asset classes, including alternatives, real assets and private equity? • Is the TDF designed to help manage volatility to keep participants invested? • Is the TDF adequately supported by plan design through auto-enrollment, auto-escalation and reenrollment?

For discussion purposes only. Not an exhaustive list of considerations.

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