Multi-Asset, Multi-Manager, and White Label Investment Options

September, 2017

AGENDA

EXECUTIVE SUMMARY

Multi-Asset, Multi-Manager, and White Label Investment Options can Improve Fiduciary Process by Creating:

- Enhanced investment outcomes
- A simplified investment menu
- Better participant understanding

Implementation Solutions Include:

- In-house management
- Outsourced, delegated fiduciary management
- Off-the-shelf options

Plan Sponsor Considerations:

- Fiduciary governance
- Fees
- Operations, communications and education

This presentation addresses the points above and includes two plan sponsor case studies that illustrate successful implementation of Multi-Manager and Multi-Asset strategies in defined contribution plans.

DEFINITIONS

Single-Strategy Option

- A traditional core investment menu option managed by a single investment manager
- The vehicle structure could be a unitized separate account, collective investment trust, or '40 Act mutual fund.
- The option may be white-labeled or include the investment manager's name.

Example: Simple Multi-Manager/Asset Option

Multi-Manager Option

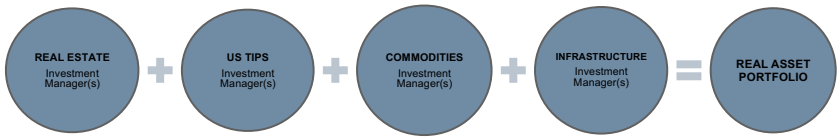
- A single investment option that is constructed utilizing more than one investment manager or investment strategy
- Combining managers and/or investment strategies provides the ability to offer greater diversity among investment management styles in a single investment option
- Many target date and custom target date funds are offered as multi-manager investment options

DEFINITIONS

Multi-Asset Option

- A single investment option that is constructed utilizing more than one asset class using either a single or multiple investment managers
- Similar to a multi-manager option, combining asset classes and investment managers provides the ability to offer greater diversity among asset classes in a single investment option

Example: Simple Multi-Manager/Asset Option



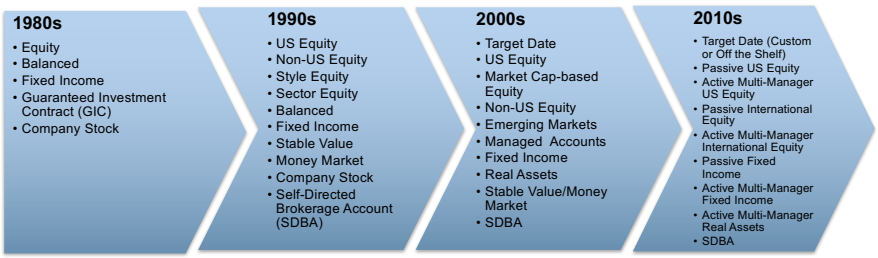
White Labeling

- Refers to the core option's **naming** convention. These options typically have no reference to the investment manager or company managing the assets.
- White label strategies may include the plan sponsor's name or may only reflect the asset class or investment objective, for example, "US Large Capitalization Stocks" or "Non-US Stocks"
- Can be applied to either a single manager or multi-manager/strategy option
- Not a new approach, as some plans have used it for decades, particularly stable value funds

Defined Contribution Institutional Investment Association

Streamlining the Defined Contribution Investment Menu

Participants Use a Small Number of Options Despite a Large Number of Offerings



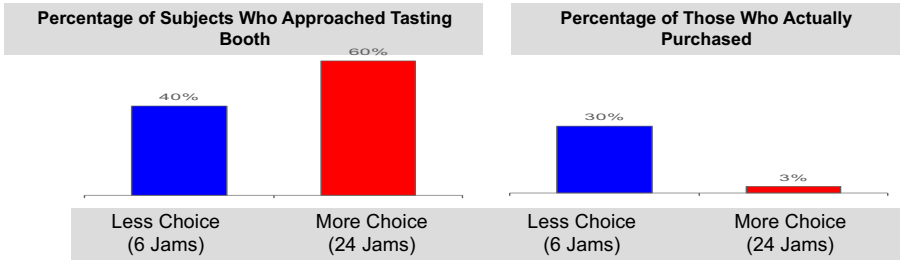
- ✓ DC investment menus expanded dramatically during the "freedom of choice" era of the 1980s and 1990s based on the belief that more choice helped participants diversify their holdings.
- ✓ The average number of investment options offered continued to increase through the 2000s, reaching a high of 18.9 in 2011 and currently at 18.1 in 2015.

However, the average 401(k) participant uses a relatively small number of options - typically 3 to 4.

Source: Russell, SEI and Vanguard "2016 How America Saves". Number of investment options offered counts each target date and risk series as a single option.

Why are so few options utilized? The Jam Study

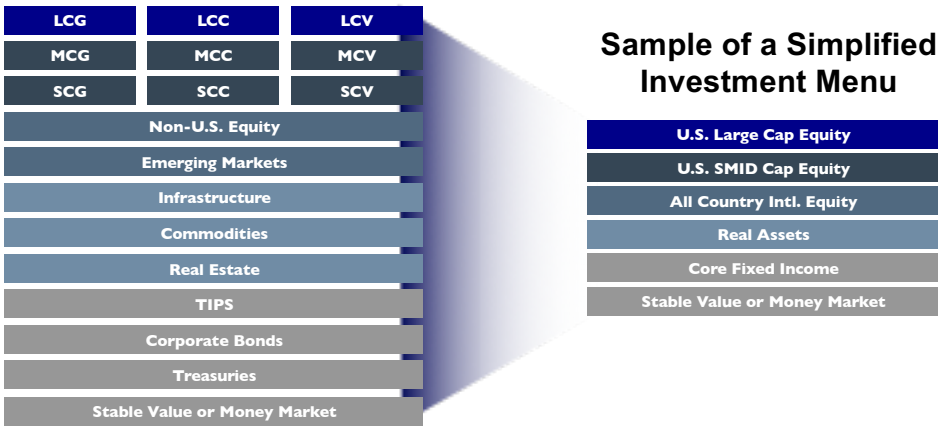
Too Much Choice is Overwhelming



- ***The Jam Study is consistent with the decline in participation as choice increases in the core investment menu***
  - Despite attracting more subjects by offering more choice in jams, subjects were less likely to purchase a jam given more choice
- Portfolios should be designed based on the risk and return characteristics of individual investment strategies. However, many participants allocate **evenly** among the available fund options – regardless of their type
- Presented with ***increased*** choice on the investment menu, participants are more likely to select the lower-risk alternatives available to them.

Simplifying the Investment Menu

Investment Menu Components



Source: Russell Investments

Simplifying the Investment Menu Using Multi-Manager Strategies and White Labeling

Multi-Manager strategies can:

- Provide more efficient exposure to a broad asset class
- Expand diversification by increasing the underlying investment exposures used for participants
  - *This may include the use of asset classes not previously offered as an investment option for participants*
- Potentially expedite the process of adding or removing a particular underlying strategy from the investment option
- Reduce extreme style exposures and narrow extreme performance outcomes
- Allow for more robust "building blocks" for custom target date solutions and managed account solutions

White labeling can:

- More accurately name the investment strategy
- Avoid potential confusion surrounding "brand names"
- Also be used for single-manager strategies

Trends In Menu Simplification, Multi-Manager And White Labeling

Menu Simplification and Multi-Manager strategies

- "67% of DC-focused consulting firms support or actively promote both multi-manager/white label fixed income and equity options" (61% for real asset strategies) – PIMCO Survey
- "20% of plan sponsors plan to consolidate the number of options in the next 18 months, and those interested in adding alternatives appear likely to do so in a multi-manager framework" – SEI Survey
- 30% of plan participants say they want to "do it themselves". This suggests a meaningful minority of participants continue to look to the core investment menu to allocate their contributions. – JPMorgan Survey

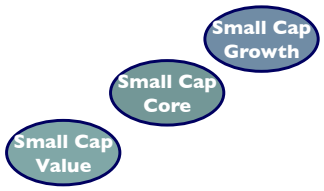
White-labeling

- 17% of plans are currently utilizing white-labeling – Aon Hewitt
- (Only) 37% of sponsors believe in the importance of brand in their participant communications – Aon Hewitt
- (Only) 23% of plan sponsors believe a "white label" solution is more difficult to communicate (to participants) – Aon Hewitt
- 31% of plan sponsors have moved to a custom target date fund – Aon Hewitt

Defined Contribution Institutional Investment Association

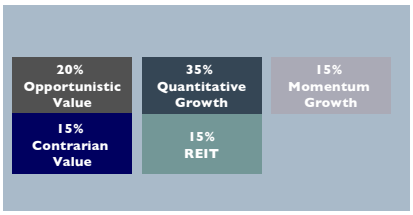
The Fiduciary Case for a Multi-Manager Framework

Traditional vs. Multi-Manager Investment Options



Traditional Small Cap Equity Menu Options

Value — Growth



Small Cap Equity Multi-Manager Strategy

Value — Growth

- ***In this example, a multi-manager/strategy approach for a small cap equity investment option for the core investment menu can provide efficient and diverse exposure in a single investment option.***
- Underlying asset allocation targets would be monitored and adjusted by professionals (typically within specified bands) to reflect current market environment in an effort to improve returns
- Individual participants would not have to determine how to allocate among many options within a similar asset class

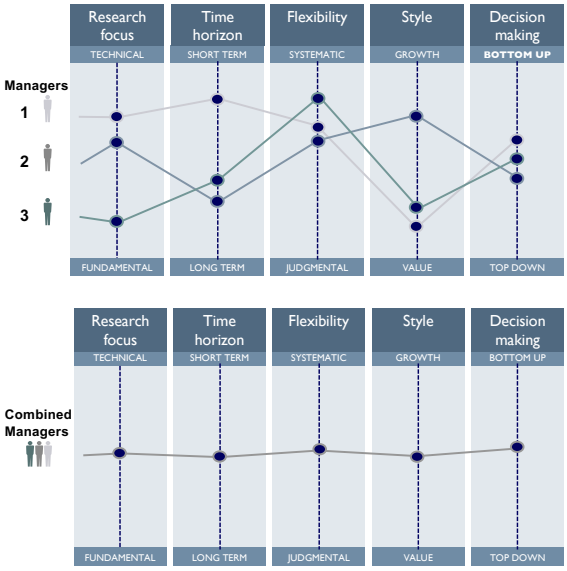
Streamlining Investment Changes

White label funds can be designed to streamline the ability to change out managers

- The specifics should always be reviewed to determine if communications need to be updated based on what has been previously disclosed and applicable legal requirements
- Avoiding brand names helps participants focus on strategy objective rather than "superstar" managers, reducing opportunity for dissatisfaction when funds are eliminated or replaced
- In some instances, communications of manager changes to participants may be accelerated as compared to "branded" single-manager funds

Investment Styles Vary – Combining Styles Can Reduce Extreme Style Exposures

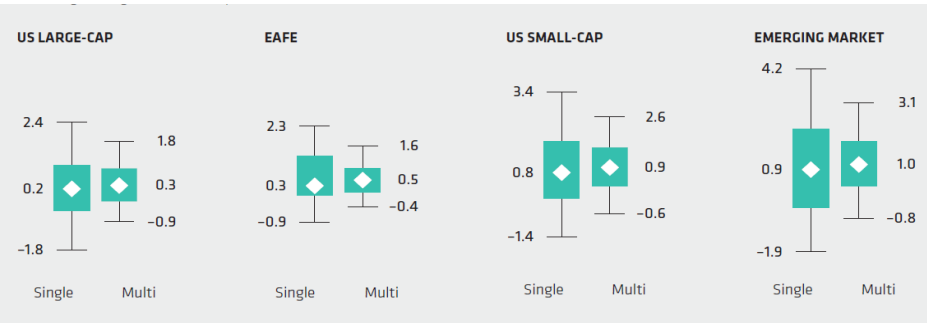
- Active investment management styles vary from manager to manager
- Investment styles can be a primary determinant for understanding periods of underperformance or outperformance vs. broader investment benchmarks
- Investment styles are expected to have different periods of performance advantage versus the relevant market indices for the investment strategy
- ***Combining investment styles in a multi-manager strategy can reduce extreme exposures to individual investment styles thereby smoothing and improving the risk/return profile of the investment option***



Multi-Manager Strategies Can Improve Results and Narrow Extreme Outcomes

A Multi-Manager Allocation has Historically Produced More Stable Returns and Improved Median Alpha Versus Single-Manager Allocation

Percentage average annualized outperformance versus benchmark, 2004-2014

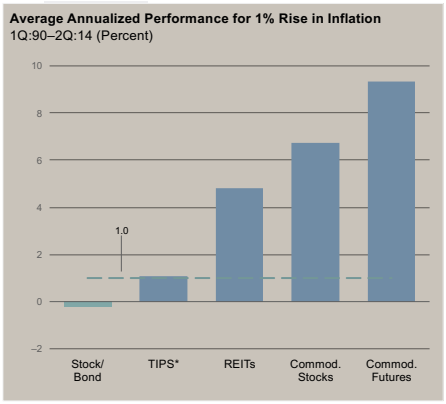


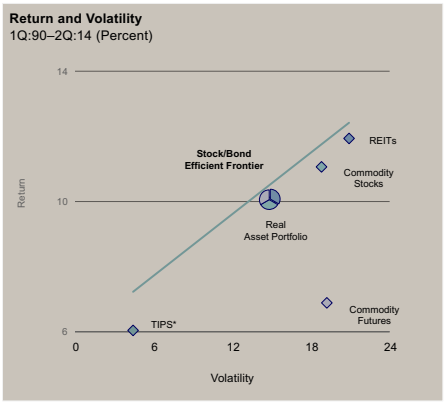
Past performance does not guarantee future results.
Single takes the percentile of all funds in each category. Multi takes the percentile of all possible equal weighted combinations of three funds within each category. Annual excess returns from 2004-2014. Benchmark for Core US Large-Cap Equity is the S&P 500 Index; Core US Small-Cap Equity is Russell 2000 Index; Core EAFE Equity is MSCI EAFE; Core Emerging Market Equity is MSCI Emerging Market. Subtracted an estimate of 63 basis points for survivorship bias based on academic papers.
Source: AB, eVestment, MSCI and Russell Investments

Narrowing the range of extreme outcomes can have a beneficial result in the long-term returns for plan participants

Multi-Asset Strategies Can Also Improve Results and Narrow Extreme Outcomes

Similar to Multi-Manager Strategies, Multi-Asset Strategies can broaden diversification while producing more stable returns and reducing volatility

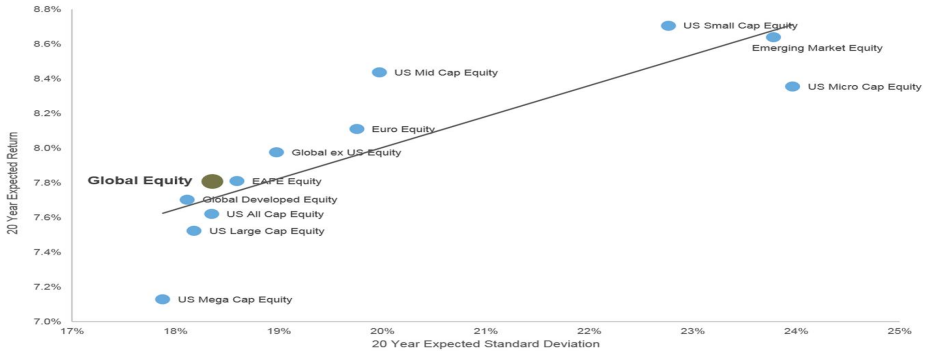




Example – Real Asset strategy

Past performance does not guarantee future results.
Through June 30, 2014
*TIPS data from 1Q:98
Source: AB, BCOM, Bloomberg, Federal Reserve Bank of Philadelphia, FTSE EPRA/NAREIT, GSCI, S&P and S&P Dow Jones

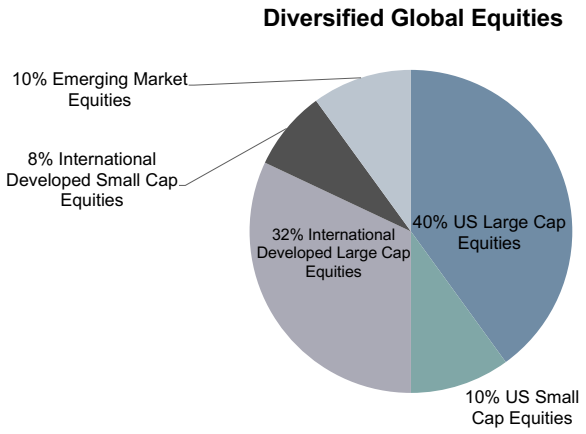
Building a Better Core Equity Option with Global Equities



- By combining asset classes and strategies with higher risk and higher return expectations, plan participants can be offered a simplified investment option covering global equity markets that can provide an attractive risk and return potential

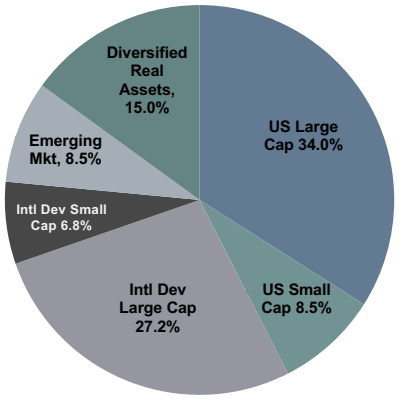
Source – Russell Investments – June , 2016 Capital Market Assumptions

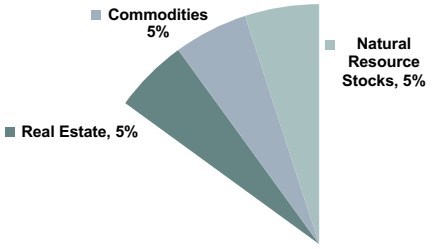
EXAMPLE: DIVERSIFIED GLOBAL EQUITIES



- One option, multiple investment strategies and/or managers
- Passive and active strategies can be combined in a single option
- Asset allocation is professionally managed and may vary over time

EXAMPLE: GROWTH OPTION – DIVERSIFIED GLOBAL EQUITIES & REAL ASSETS





- One menu option, multiple investment strategies and/or managers including Real Assets
- Inclusion of Real Assets gives the portfolio manager of the multi-manager option the ability to access asset classes that can hedge inflation risk

Example: Growth Option - Diversified Global Equities, Real Assets & "Alts"

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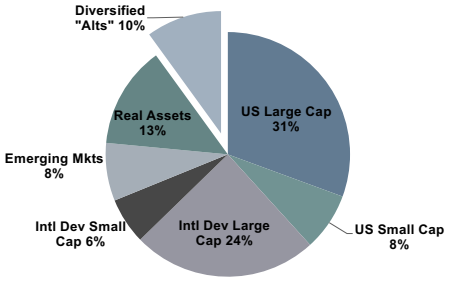
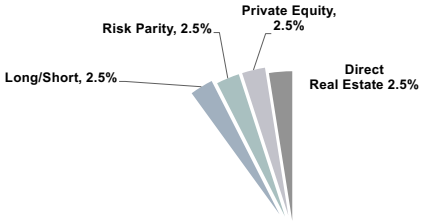
Global Equities/Real Assets/"Alts"



Diversified "Alts" Breakdown



- One option, offering maximized diversification including a limited exposure to institutional alternative investments in an effort to improve returns and reduce volatility
- Allows for the inclusion of asset classes and strategies that have not historically been used in defined contribution plans*
- **Definition of "Alts"** - "Most practitioners include hedge funds, private equity, infrastructure and (direct) real estate under the "alternatives" umbrella"*

* See "Is it Time to Diversify DC Risk with Alternative Investments" – *DCIIA*, May 2013

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Multi-Manager Strategies Decision and Implementation Process

DEFINITIONS

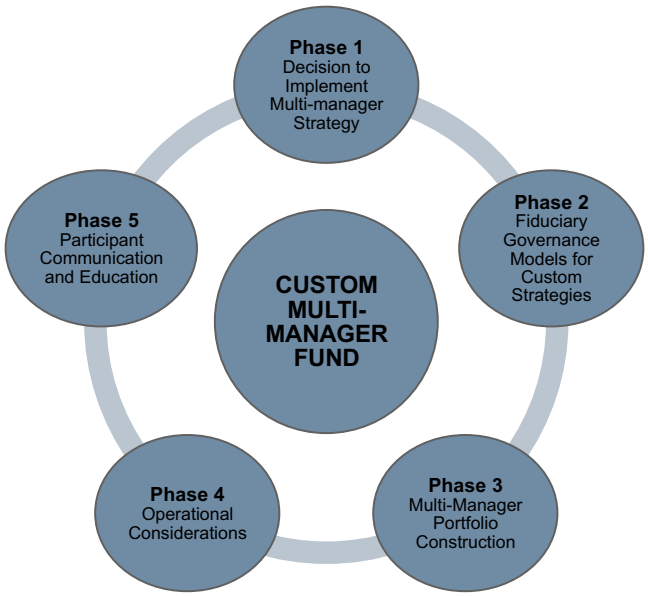
Custom multi-manager option

- Built with two or more underlying portfolios
- Unitized to be a single investment option with a single price (NAV) through a separate account, custom collective trust or custom mutual fund structure
- Underlying portfolios may be a mix of mutual funds, collective investment trusts, and separate accounts
- Plan Sponsor or designated fiduciary manager selects and manages the underlying investment manager portfolios, asset allocation, and rebalancing frequency

Off-the-shelf multi-manager option

- Built with two or more underlying portfolios
- Packaged in a CIT or mutual fund vehicle with a single price (NAV) and offered as a single investment option
- Strategy provider selects underlying portfolios, asset allocation, and rebalancing frequency

SAMPLE CUSTOM FUND IMPLEMENTATION PROCESS



Phase 1 - Decision to Implement Multi-Manager Strategies

Multi-Manager Investment Option Decision: Custom or Off-the-shelf?

Custom Multi-Manager Option:

- Plan sponsor and/or delegated fiduciary manager are responsible for:
  - Portfolio manager or fiduciary manager selection
  - Defining the investment objective for the option
  - Asset allocation
  - Underlying investment manager selection
  - Rebalancing
  - Investment vehicle service provider
  - Custodian
- A more detailed discussion of the duties of the plan sponsor or duties delegated to a fiduciary manager are covered in the following pages

Off-the-shelf Multi-Manager Option:

- Plan sponsor or designee responsible for:
  - Selecting an investment provider that is responsible for asset allocation, manager/strategy selection, and rebalancing
  - Plan sponsor will need to decide whether to white label
  - May not require material changes to IPS or record-keeper processes
- Provide access to a multi-manager solution where there are limited plan assets
- Typically has an existing fund track record
- Off-the-shelf option will have communication and education materials for participants

Phase 1 - Decision to Implement Multi-Manager Funds

Consideration for Custom Multi-Manager Funds

Plan's service providers
- ❑ Can custodian/trustee and record keeper integrate a custom strategy?
- ❑ Will existing agreements need to be amended?
- ❑ Evaluate impact on fees and expenses

Core menu structure
- ❑ Will all or some menu options be multi-manager strategies?
- ❑ How will the options be named?
- ❑ Mapping and black-out dates

Communications and education
- ❑ Initial and ongoing communications
- ❑ Fact sheets, website data availability, performance track records
- ❑ Annual regulatory reporting requirements
- ❑ Evaluate impact on costs

Plan's existing documents
- ❑ Investment Policy Statement
- ❑ Trust documents and/or other governance documents

Phase 2 – Fiduciary Governance Models for Multi-Manager Funds

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Fiduciary Assistance for Plan Investment Menu Decision Making – Role of an investment consultant

Advice - A traditional 3(21) investment consultant can advise plans on the construction of a custom approach including asset allocation and investment manager recommendations or recommend off-the-shelf multi-manager options

Delegated Fiduciary Manager - A 3(38) discretionary investment manager has the ability to implement, monitor and replace off-the-shelf multi-manager solutions on a delegated basis for the plan sponsor

Retention of an investment consultant or delegated manager is not mandatory, but is a common practice for plan sponsors.

Phase 2 – Fiduciary Governance Models for Multi-Manager Funds

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	Plan Fiduciary	3(21) Consultant	3(38) Delegated Fiduciary	3(38) Off-the-shelf Funds
Selection & Replacement Process	Plan fiduciary responsible	Plan fiduciary is responsible with non-discretionary assistance from consultant	Discretionary manager responsible for decisions and plan sponsor retains responsibility for selecting and monitoring discretionary manager	OTS investment manager is responsible for all underlying manager decisions and plan sponsor retains responsibility for selecting and monitoring OTS manager
Investment Monitoring Process	Typically quarterly	Typically quarterly	Agreed upon by plan fiduciary and delegated fiduciary. Typically daily.	Typically daily
Fiduciary Accountability	Plan fiduciary	Plan Sponsor and Consultant as "co-fiduciaries"	Discretionary Manager. Plan fiduciary has a more limited role	OTS Investment Manager. Plan fiduciary is primarily responsible for the OTS product and its manager
Complexity Level for Plan Fiduciary	High. Do It Yourself, no delegation	Medium. External fiduciary assistance. Plan fiduciary retains decision authority.	Low. Full delegation that may include the use of OTS Funds	Low. Full delegation to OTS fund manager for underlying fund investments

Phase 2 – Fiduciary Governance Models for Multi-Manager Funds

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Fiduciary Models – Benefits and Challenges

Plan Fiduciary Builds
- Benefits– plan sponsor controls design, implementation, and monitoring; potential for consistency and scale across various plans
- Challenges–higher level of complexity requiring significant breadth and depth of internal resources, experience, and assets; greater fiduciary responsibility

3(21) Non-discretionary Consultant Assists
- Benefits– consultant can assist with selection of an off-the-shelf strategy or with the creation of a plan fiduciary - built strategy; breadth and depth of consultants' resources, experience, and fiduciary support can be leveraged
- Challenges– final decisions rest with plan fiduciary

3(38) Delegated Fiduciary Manager (custom strategies)
- Benefits– breadth and depth of managers' and plan's resources, experience, and assets can be leveraged; higher level of customization as compared to an off-the-shelf approach; maximized fiduciary support for the plan fiduciary
- Challenges –investment minimums may be high

3(38) Multi-Manager ("off-the-shelf" strategies)
- Benefits– Access to the breadth and depth of managers' resources, experience, and assets; maximized fiduciary support; lower level of complexity for plan fiduciary
- Challenges –low level of customization; legal documents may not be negotiable

Phase 3 – Multi-Manager Portfolio Construction

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If selecting an **off-the-shelf** strategy, the strategy provider will be responsible for constructing the portfolio.

If selecting a **custom** implementation, portfolio construction steps may include:
- Defining the investment objective
- Establishing the investment policy
- Permitted asset classes, investment vehicles and strategies
- Asset allocation ranges
- Monitoring and replacement process for underlying managers
- Rebalancing process
- Liquidity management
- Selecting and organizing underlying investment portfolios and managers
- Negotiating and evaluating fees and fee breakpoints

PHASE 3 – MULTI-MANAGER PORTFOLIO CONSTRUCTION

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Evaluation of Fees

It is important to note that plans need not seek to implement the "lowest cost" option, but rather should make decisions based on the relative value of services provided.

Relevant costs to evaluate may include:

- Record keeping
- Trustee/custodial services
- Consulting
- Communications
- Legal support
- Investment management
- Internal resources and staff
- Performance attribution

Plan sponsors may be able to leverage their size and scale and/or existing relationships to reduce overall fees. Additionally, implementing institutional vehicles may provide potential cost reductions.

PHASE 3 – MULTI-MANAGER PORTFOLIO CONSTRUCTION

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Rebalancing Methodology

- A custom strategy is rebalanced in accordance with its adopted rebalancing procedures
- Quarterly rebalancing is most common
- Technology is available to automatically rebalance to strategic asset allocation bands
- Asset allocation bands can be set at the asset class and/or investment manager level
  - Establish acceptable "bands" around the desired strategic asset allocation which dictate the point at which rebalancing is desired
    - Example: A Large Cap Equity strategy is 15% large cap momentum growth strategy, rebalancing band of +/- 3% from strategic target

Special Considerations for Multi-Manager strategies that include illiquid assets

- Need to understand liquidity restrictions and costs, such as "gates", or if daily liquidity is not available
- Liquidity constraints may require broader strategic asset allocation bands
- Consider if illiquidity may trigger redemption "gate" violation resulting in a failed rebalance transaction
- Entry and redemption transaction timing for underlying investments

PHASE 4 – OPERATIONAL CONSIDERATIONS

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Comparison of Multi-Manager Packaging

- The majority of custom multi-manager funds are constructed as unitized separate accounts or custom collective investment trusts (CITs).
- Off the shelf funds are typically offered as mutual funds or CITs.
- Unitized separate accounts offer the highest level of customization, but also have the highest level of involvement for the plan fiduciary or their fiduciary designee

Vehicle Type	Unitized Separate Account	CIT	Mutual Fund
Customization	Yes	Not typical	Not typical
Level of Third Party Fiduciary Governance	High (If Outsourced to a 3(38))	High (Trust Company Investment Committee)	High (Fund Board of Directors)
Access to Data	Yes	Often negotiable	Dictated by Investment Company Act of 1940
Investment Fees	Negotiable	Often negotiable	Typically non-negotiable
Custody and Administration Costs	Variable (minimum fee may apply)	Fund level, not direct plan expense	Fund level, not direct plan expense
Regulatory Investment Restrictions (i.e., use of leverage or illiquid assets)	Flexible	Moderate	Restrictive
Operational Requirements/Complexities	Varies (depending on level of outsourcing)	Low	Low
Minimum $ Investment	Often higher than other vehicles	Varies (typically low)	Low
Participant Access to Information	Customized	Good	Good
Rebalancing Responsibility	Plan Fiduciary or designee	Fund Fiduciary Manager	Portfolio Manager/multi-manager provider

PHASE 4 – OPERATIONAL CONSIDERATIONS

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Unitized Separate Account

Typically, custom multi-manager strategies are implemented using the Trust Unitization approach although some large plans have utilized collective trust and, less commonly, custom mutual fund structures

Trust Unitization Approach

- Individual accounts are typically open for each underlying portfolio within the strategy, then consolidated to create an aggregate market value.
- Individual accounts allow for reporting at the investment manager level, as well as applying manager specific fee schedules to the appropriate balances.
- Individual accounts provide the manager with a record of their data (trades, holdings, etc.) and facilitate manager specific performance calculations.

The unitization of the strategy is accomplished by taking the aggregate, fully accrued market value of the individual accounts and dividing it by the outstanding units of the pool. From there, the unit value (Net Asset Value or NAV) can be applied as a stand alone investment option.

* For more information on implementing the different vehicle types, please see Appendix slides 59-61.

PHASE 4 – OPERATIONAL CONSIDERATIONS

Sample Players and Key Roles for Custom Strategies*

Consultant

- Provide asset allocation
- Define rebalancing rules
- Analyze exchange/mapping rules

Record-Keeper

- Receive Net Asset Value (NAV) from Custodian
- Rebalancing and liquidity management
- Trading protocol
- Create fact sheets
- Participant communications and performance reporting
- Exchange/map participant records

Custodian

- Unitize the multi-manager strategy and strike daily NAV
- Rebalancing and liquidity management

* For more detailed information please See Appendix slides 62 and 63

PHASE 4 – OPERATIONAL CONSIDERATIONS

Managed Account Compatibility

Managed account providers can use custom or off-the-shelf multi-manager strategies in their asset allocation models similar to the way traditional DC investment options are utilized

Managed account providers typically consider the following elements when constructing their models:

- fees
- portfolio turnover
- historical manager performance
- active risk
- risk factor exposures
- portfolio holdings history

Additional information may be needed for custom multi-manager strategies. Examples include:

- composite performance for the underlying funds/strategies
- asset allocation policy targets

Phase 5 – Participant Communication and Education

Multi-manager strategies can streamline communications and reporting

Consider the impact on your initial and ongoing communications in the following areas:

- Strategy descriptions and names
- Fact sheets
- Performance reporting
- Direct disclosures, risk disclosures
- Website reporting
- Documents to be available
- Coordination with SEC disclosures, if applicable
- Required ERISA disclosures
- Black-out notices and fund mapping

Make sure to coordinate across providers

Consider the impact to your participants in the following areas:

- Core options that are not "branded"
- Core options that include the Plan or company name

Phase 5 – Participant Communication and Education

Sample Communication Plan for a Menu Redesign

Scope
Have a clear investment menu design and strategy to map current assets

Tasks
Identify the participants affected by the investment menu redesign
Create a communications strategy on how and when to inform participants

- What is changing?
- When is it changing?
- What are the options?
- Remind participants at regular intervals prior to the change
- Announce that the change was completed

Review with service providers to create a message that helps participants appreciate the added value and benefits

Potential Misperceptions to Address
If employer-branded:

- The offerings may be seen as managed by the employer instead of the fiduciary manager
- Removing familiar brand names may upset some participants and be perceived as taking something away

Custom Funds – Ongoing Fiduciary Monitoring and Governance

FIDUCIARY PROCESS: DOCUMENT, DOCUMENT, DOCUMENT

Legal Considerations

As with other plan investment options, multi-manager strategies require legal support to ensure regulatory, fiduciary, participant communications and structural considerations are addressed.

In addition to ensuring compliance with plan guidelines and the law, specialized legal professionals may need to review the implications of regulatory requirements and safe harbor rules for asset allocation, plan documents, fee and expense policy, provider agreements, fiduciary governance, etc.

Discuss the fiduciary roles associated with multi-manager strategies and opportunities to allocate fiduciary responsibilities with your consultant and legal professional.

Discuss the monitoring and assessment of the impact of ERISA litigation decisions and changes in law with your consultant and legal professional.

Ongoing Monitoring and Governance Checklist

- ❑ Annual Form 5500 filing at the plan level
- ❑ Annual Audited Financial Statements
- ❑ Annual fee disclosures for investment products
- ❑ Quarterly fund fact sheets
- ❑ Periodic performance disclosures
- ❑ Summary Annual Report
- ❑ Summary Plan Description
- ❑ Summary prospectus or similar document
- ❑ Form S-8 for plans with company stock
- ❑ Provider 408(b)2 disclosures
- ❑ Black-out notices and Sarbanes-Oxley disclosures
- ❑ 404(c) notices and required information
- ❑ Potential for filing with National Futures Association (NFA)
- ❑ Disclosure of changes

Case Studies

HANESBRANDS INC. – CASE STUDY

Plan Overview

- $600 million 401(k) Plan
- 2,000 participants
- Utilize auto-enroll and auto-escalation
- Initial QDIA was Stable Value; switched to Target Date after plan inception but assets remained anchored in Stable Value

Company History

- Winston-Salem, NC based apparel manufacturer
- Firm spun-out from Sara Lee in 2006
- Index based plan established at start-up during 2008 with the Plan offering essentially the same lineup with modest modifications from Sara Lee Plan

HANESBRANDS INC. – INVESTMENT PROCESS

- Goal was simplification of the plan's investment options
- Searches done across asset classes – large cap domestic equity, SMid cap domestic equity, international equity, global fixed income, and domestic core plus fixed income
- Target date fund searches done separately based on demographics
- Use of existing DB managers / strategies where possible
- Within each category, focus on two diversifying strategies with low correlations (with exception of real assets strategy where multi-strategy firms were analyzed)
- Manager search and review for individual options and TDF done over a 4 month period
- Re-enrollment process started in May 2014 with implementation of new structure in June 2014 with heavy emphasis on asset allocation implementation and focus on target date funds

HANESBRANDS INC. – WHITE LABEL MULTI-MANAGER IMPLEMENTATION

Prior to White Label		White Label Multi-Manager Implementation	
Domestic Equity *(5 Options)*	**30.1%**	**Target Date Funds**	**70.7%**
Stable Value	**28.9%**	Company Stock	**11.5%**
Target Date Funds	**17.5%**	**Stable Value**	**6.6%**
Company Stock	**9.1%**	U.S. Large Cap Equity	**4.8%**
Balanced Fund	**6.1%**	U.S. SMid Cap Equity	**3.0%**
International Equity Index	**4.2%**	International Equity	**1.8%**
Bond Index	**2.9%**	U.S Bond	**0.8%**
TIPS	**0.7%**	Global Bond	**0.4%**
Asset Allocation Option	**0.5%**	Real Assets	**0.4%**

Observations

- Plan was almost completely composed of passive offerings with 13 investment options
- A significant portion of participant allocations were in the Stable Value Fund
- The participants tended to have fairly stable allocations without a great deal of movement amongst options historically

HANESBRANDS INC. – KEY TAKEAWAYS

- Re-enrollment to QDIA process focused on re-educating workforce
- 10% of population elected to move into new options
- Many participants "chose" to stay in QDIA
- Significant reduction in Stable Value option
- Participant asset allocations more closely aligned with retirement goals

COMMONWEALTH OF MASSACHUSETTS – CASE STUDY

Smart Plan –
Massachusetts Deferred Compensation

Plan Overview

- $7 Billion 457 Governmental (non-ERISA) Defined Contribution Plan
- 268,000 participants
- Investment Menu:
  - Tier 1: Stable Value and Custom Target Date Funds (SMART Funds)
  - Tier 2: Passive core options
  - Tier 3: White-Labeled Multi-Manager options, primarily active, referred to as "Plain-Label"
  - Self-Directed Brokerage

Commonwealth of Massachusetts - Plain-Labeling Initiative

- Embrace belief that asset allocation drives return and design a menu that emphasizes asset classes versus individual funds
- Provide for diversification "underneath-the-hood" within white-label investment options
- Increase flexibility of adding and replacing managers within core menu
- Address concern that participants were potentially investing more with better known retail managers and avoiding some lesser known institutional managers
- Streamline the investment menu to reduce confusion and promote simplicity
- Introduce institutional best practices to incorporate DB best of breed managers as well as leverage scale to drive down investment fees where possible

Commonwealth of Massachusetts – Solutions to Potential Issues

Inception Date

- Issue: How to account for the track record?
  - Newly created "plain-label" option doesn't have a track record
  - However, underlying funds have historical track records
- Solution:
  - Blended the historical performance, footnoted accordingly through disclosures
  - Provided access to information for each underlying manager's actual historical track record

Fixed Income/Monthly Dividend Funds

- Issue: How to account for the monthly dividend?
  - Via the traditional menu structure participants were able to see the dividend
  - "Plain-label" format doesn't allow for transparency of the dividend payment
- Solution:
  - Created communication materials to provide explanation
  - Received some questions, but not overly voluminous

Commonwealth of Massachusetts – Evaluation of Costs

Potential Increases

- Hard Dollar Costs:
  - Costs are real and an area plan sponsors must take into consideration, less of an issue for bigger plans as opposed to smaller plans
  - Major cost incurred was related to the unitization costs, approximately $4-5K per strategy per year, rather insignificant given size of plan
- Time Allotment:
  - Ongoing monitoring of underlying investment managers
  - Asset allocation review and rebalancing

Potential Decreases

- Investment Fees:
  - Often found the overall investment fees decreased even when unitization costs were taken into account given the lower priced institutional vehicles that could now be offered in their "plain-label" format
- Education and Communication Fees:
  - Given individual managers can be added and replaced by plan fiduciary, found the communication and education effort less onerous on the record-keeper which helps reduce administration costs

Commonwealth of Massachusetts – Investment Menu Redesign Summary

Before Investment Menu Redesign

- ❑ TDFs, stable value
- ❑ 5 Passive Options
- ❑ 8 Active Strategies
- ❑ 2 White Label/Multi-Manager Funds Utilizing 5 Underlying Strategies

After Investment Menu Redesign

- ❑ TDFs, stable value
- ❑ 5 Passive Options
- ❑ 3 White Label/Single-Manager Active Funds
- ❑ 7 White Label/Multi-Manager Active Funds Utilizing 18 Underlying Strategies
- ❑ Self-Directed Brokerage

- **Improved manager diversification without increasing the number of funds**
- **Simplified menu by migrating all active funds to white label funds with "Plain-Labeling"**
- **Enhanced future flexibility with white label structure**

Commonwealth of Massachusetts – Communication and Education Rollout

- Began the communication and education efforts 30-60 days prior to going live
- Updated the website with pertinent information
- Guiding Principles Participant Materials
  - Defining clearly and upfront what is taking place
  - Reasons for moving the menu in this direction
  - How would it impact the participants
  - How would it benefit the participants
- Working group anticipated participant push-back and phone calls, however there was very little participant pushback

Commonwealth of Massachusetts – Communication and Education Rollout

- The biggest challenge was to see the project through
- The Plan's new investment menu structure allowed for:
  - Simplified institutional menu with better diversification
  - Participant access to lesser known, high-quality institutional boutique managers
  - Lower investment fees through the use of collective trusts and/or institutional separate accounts

Conclusion

EXECUTIVE SUMMARY

Multi-Asset, Multi-Manager, and White Label Investment Options can Improve Fiduciary Process by Creating:

- Enhanced investment outcomes
- A simplified investment menu
- Better participant understanding

Implementation Solutions Include:

- In-house management
- Outsourced, delegated fiduciary management
- Off-the-shelf options

Plan Sponsor Considerations:

- Fiduciary governance
- Fees
- Operations, communications and education

This presentation addresses the points above and includes two plan sponsor case studies that have successfully implemented Multi-Manager and Multi-Asset strategies

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Defined Contribution Institutional Investment Association

Appendix

Implementing Custom Strategies with Unitized Separate Accounts

Can be the least expensive, most flexible and least restrictive means to deliver white label strategies which requires the highest level of involvement by the plan fiduciary unless outsourced.

Pros	Cons
Unlimited flexibility in pursuit of investment strategies	No pooling of assets permitted, which may reduce economies of scale, but may use CITs
Full flexibility in product design such as fees and liquidity	May be difficult for participants to understand without added communication
Investment strategy can be fully customized at the client level	Clients must be allowed to dictate investment limitations to managers
Not affected by contribution/redemption activity of other investors	Potentially higher required investment minimums for the plan sponsor
Full transparency, custody control and liquidity	Potentially more expensive costs for custody in particular
Can be the fastest and easiest to establish compared to custom collective trust and custom mutual fund options	Increased interaction, due diligence with investment manager(s)

Implementing Custom Strategies with Collective Investment Trusts

DB and DC plans have used collectives for decades and DC plans have been increasing the use of these in an effort to reduce costs and improve diversification of and within investment offerings

Pros	Cons
Allows for pooling of specific types of institutional assets	Must be maintained by a bank or trust company
Greater flexibility for types of investment strategies than US mutual funds	Investors limited to certain types of tax-qualified retirement plans, government plans, other collective trusts and insurance company separate accounts
Can be less expensive to organize and operate than mutual funds	May be more difficult for participants to find third party information about the strategies
Generally lower cost for plan participants relative to mutual fund offerings	Not available to individuals outside of their retirement plan
Built-in governance as compared to a separate account	Banking regulators responsible for oversight (OCC or state bank commissions, no SEC oversight) not seen as strong as SEC

Implementing Custom Strategies with Mutual Funds

Generally, the highest level of governance (i.e., strict regulatory requirements), but comes at a higher cost than collective trust and unitized separate account offerings. Also has the highest level of investment restrictions of the three vehicles.

Pros	Cons
Ability to pool assets across plans (e.g., 403b, 401k and 457) and potentially with other plans	Investment management fees are fixed at the fund level
Can be used in IRA accounts	May have higher fees than the unitized or collective trust options
Not subject to ERISA plan asset rules	Commingling of retail and retirement assets may increase portfolio costs, but may benefit from economies of scale in asset management fees
Wide array of investment strategies are possible	Limited ability to use leverage, illiquid investments, etc. under the Investment Company Act of 1940
Daily liquidity provided to investors at the end of each trading day	Limits diversification into illiquid and leveraged investment strategies used by pension investors
SEC-regulated governance structure with Investment Manager and Board of Directors	Could limit flexibility

Phase 4: Operational Considerations

Sample Operational Tasks for a Unitized Separate Account

❖ **Process Participant Activity (Record Keeper/Custodian)**
Daily participant cash and unit transactions are delivered to the trustee and custodian from the record keeper. The custodian processes the activity into the trust accounting system based on the category detail provided.

❖ **Process Trades**
The record keeper places all mutual fund/commingled trades with the appropriate investment managers within their respective deadlines. The custodian posts daily mutual fund/commingled trades to the trust accounting system based on the electronic report provided by the record keeper.

❖ **Reconcile Cash**
The custodian moves daily cash flows based on the report provided by the record-keeper and settles all associated trades with investment managers. The custodian then initiates all necessary wires and receives any incoming wires as directed by the reported activity.

❖ **Process Expenses**
The custodian posts daily expense accruals to the accounting system based on accrual estimates as directed and agreed upon by the client. This accrual approach ensures that fees are appropriately allocated to participant balances. Expenses may be for investment management or other plan support services. Plan sponsor must authorize payment of all invoices to be charged against the accrued expenses within the trust.

❖ **Reconcile Share Balances**
The custodian reconciles mutual fund/commingled share balances on a daily basis with each investment manager. Share positions for separately managed accounts may be reconciled less frequently than daily, but still would be reconciled at least once a week.

Phase 4: Operational Considerations (continued)

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- **Process Income**
The custodian will accrue income – where appropriate – for income-producing securities. Dividends will be accrued on ex-date and held as a receivable until the dividend is received. Both of these accruals affect the NAV.

- **Price Holdings**
All holdings are valued by the custodian via the pricing service that entity utilizes. Custodians typically receive daily vendor feeds into the trust accounting system, which are then applied to current share positions to calculate total market value by fund.

- **Calculate Unit Value**
Once total market value is calculated, the custodian adds assets and subtracts liabilities to get net cash. Next, net cash is added to current market value to calculate total net assets. The total net assets are then divided by the number of outstanding participant units for the unit value per share.

- **Rate of Return**
The custodian performs a daily rate of return review in which the current day unit value performance is compared to that fund's underlying asset performance (commingled/mutual fund).

- **Return on Underlying Asset**
Unit Value Return vs. Underlying Asset Return Unit value returns are compared to a benchmark (as agreed to by the plan sponsor) for those funds that have separately managed underlying assets.

- **Final Audit**
The custodian performs a final review of the current day's valuation. The unit value calculations and rate of returns are reviewed and signed off by a team leader/ auditor before the final prices are delivered to the record-keeper.

White-Label and Multiple-Manager Structures: Resources

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Russell: http://www.russell.com/documents/institutional-investors/research/core-what-is-it-good-for.pdf

AON Hewitt:
http://www.aon.com/human-capital-consulting/retirement/investment-consulting/bin/pdfs/White_Label_Funds_in_DC_Plans.pdf
http://www.aon.com/attachments/human-capital-consulting/custom-dc-investments-for-participant-success-wp-july2015.pdf

BlackRock: Delta case study: https://www2.blackrock.com/webcore/litService/search/getDocument.seam?contentId=1111128313&Source=SEARCH&Venue=PUB_INS

SEI: http://www.plansponsor.com/NewsStory.aspx?id=6442498324&page=3

INVESCO: Participant communication materials

Wellington: "Structuring Multi-Manager Investments for DC Plans" May 2013

MFS: http://conferences.pionline.com/uploads/conference_admin/Defined_Contribution_Investing.pdf

PIMCO: Consultant Survey: http://media.pimco.com/Comm/documents/13-0437-DC%20Survey%20Highlights%202014.pdf

Callan: https://www.callan.com/about/newsroom/files/inthenews/benefitsqtrly_3q13.pdf

P&I Supplement: http://conferences.pionline.com/assets/PI_020314_401K_supp_LR_BK.pdf

State Street DC Trends: http://www.ssga.com/definedcontribution/us/docs/SSgADC_TrendsUpdate.pdf

JP Morgan: Core Menu Innovation: https://am.jpmorgan.com/blobcontent/1378404661435/83456/WP-RI-Focus_Your_Aim_Final.pdf

