

Managed Accounts

What to Consider When Selecting a QDIA

Third in a Series

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EXECUTIVE SUMMARY

DCIIA has developed this series of questions and answers to assist plan sponsors in working with their fiduciary committee (Committee) to evaluate, select or make changes to the defined contribution (DC) plan's qualified default investment alternative (QDIA). When selecting a QDIA, there are many variables to consider. Here, we present the perspectives of managed accounts (MA) providers and target date fund (TDF) providers as well as investment consultants and ERISA counsel where relevant.

This paper is the third in a series of papers on the topic of MAs. The first two papers include:

- A primer that provides an overview of the key aspects of managed account programs today. It reviews the basics of MAs, a summary of usage over time, a description of how they can be offered, and considerations for determining if they are right for a particular plan.
- A detailed look at due diligence considerations and the requirements for implementation of managed accounts, as well as a comprehensive sample request for proposal (RFP).

DCIIA encourages plan sponsors to follow a prudent process when making any decision about investment options and plan design, and to rely on prudent experts, when warranted, for assistance.

INTRODUCTION

This paper poses several questions that a typical Committee might ask when evaluating a QDIA, whether the QDIA is a professionally managed account program or one composed of target date funds (TDFs). Briefly, a managed account can be defined as a customized discretionary portfolio managed for a DC plan participant based on the personalization factors that are provided to the managed account provider. It can also include services to help identify optimal savings rates and help with retirement planning. A TDF is a fund of funds that automatically adjusts its asset mix in the same way for all invested participants until it reaches its stated target date. Typically, the aggressiveness of the fund will reduce as the target date approaches. In general, a TDF is used to facilitate a typical asset allocation for a specific cohort of plan participants.

Other important differences between MAs and TDFs are reviewed below. While a balanced fund can also be used as a QDIA, its use is less prevalent and as such is not considered in this paper. Responses from both MA and TDF providers are also included below, with additional perspective offered by investment consultants and, as appropriate, ERISA counsel, who are often involved in these decisions.

FIDUCIARY COMMITTEE QUESTIONS

#1 *The demographics of our plan are currently heavily skewed to the millennial generation (employees born between 1981 and 1996). Which QDIA is best for this age cohort? We will consider factors such as: saving impact; appropriate investment allocation; transparency of investment methodology; and fees.*

Managed Account (MA) provider: While many millennials enrolled in MAs are likely to receive similar asset allocation recommendations and are therefore less likely to benefit from a personalized investment recommendation, there are other aspects of a MA service that have the potential to add value for younger participants. For one, younger participants are likely to benefit from a customized savings rate recommendation and a projected retirement date. Further, building positive, personalized “savings habits” early in their careers should position them for financial success later in life, helping to prevent the surprise and disappointment that many investors face when they realize they have under-saved and fallen short of having the savings required to achieve a successful retirement. Finally, introducing the idea of adding personal information as their careers and life circumstances develop may be of benefit for the future, even if they are not yet ready to proceed with this step.

The fees charged for MA services are typically based on account balance. Therefore, younger participants, who generally have low account balances, may receive personalized advice for a relatively

low cost, compared to other personalized advice services. Many younger cohorts are looking for financial support to tackle student loans, budgeting, emergency savings, and other financial considerations. In fact, one managed account provider found that during the market volatility of the first quarter in 2020, younger employees actively enrolled in managed accounts at a higher rate than normal: 65% of newly enrolled members were under the age of 50.¹

A MA user experience typically extends beyond investment allocation to personalized advice delivered online, as well as potentially through mobile apps and in-person through call centers or on-site advisors. The personalized digital experiences offered by MA providers are likely to appeal to younger employee populations.

Target Date Fund (TDF) provider: TDFs can be an ideal QDIA for younger participants. At their stage in life, millennials’ most valuable asset is their human capital (future earnings and contributions). TDFs are a logical choice for them because these participants have time on their side and share relatively similar demographics. TDF glide paths address younger participants’ needs with a significant equity allocation while providing some diversification with other asset classes. These funds will keep millennials appropriately age-diversified across a wide spectrum of market environments. Since many younger participants are not yet familiar with investing, TDFs provide the investment structure they need. With a TDF, they receive a broad asset allocation appropriate for their age, typically for no additional fee other than the expense ratio of the particular TDF. And, importantly, TDFs are relatively transparent, disclosing to participants the asset allocation that will be used and the historical performance of the funds. This helps millennial participants, when they are ready to engage, evaluate whether that TDF has an approach and investment risk level that is appropriate for their savings.

It makes intuitive sense that participants further away from retirement and with smaller balances are less likely to engage with financial planning tools. Furthermore, research shows that most individuals are unable to consider planning decisions more than 10 years into the future, as they are disconnected from their “future self.”² Thus, TDFs are a good choice for these younger participants.

Investment Consultant Perspective: Both MA and TDF providers’ points of view have merit. As we look at trends in participant behaviors over time, we see that the percentage of plan assets in TDFs grew from 2009 to 2018: 9% to 35% of the growth was attributable to asset allocation,³ and 16% to 57% of it was attributable to annual contributions.⁴ This growth was tied mainly to new hires during that time period, since the percentage of new hires allocating solely to a TDF grew from 49% to 84%. Millennials were a driving force in this group of new hires: participants born between 1981 and 1996 who are currently ages 24 to 39 who invested solely in TDFs had grown from 50% in 2009 to 84% by 2018.⁵ Therefore, we believe that

the millennial generation, through default or active election, demonstrates a general comfort level with TDFs.

While there is a benefit to the personalized savings rates that can come with a MA—in many instances, a higher savings rate for participants, especially the millennial generation—we have seen an increase in the use of auto features, which also helps to set a solid foundation for savings rates. In 2014, for instance, 40% of DC plans had adopted automatic enrollment; five years later, 46.3% had.⁶ The use of auto features helps to facilitate the benefit of compounding early on, as many plan sponsors couple automatic enrollment with automatic escalation.

For an employee population skewed towards millennials, we typically observe an overlapping overall equity allocation range from 80% to 99% for those invested in either a TDF or a MA. From that perspective, we don't see a meaningful investment rationale for choosing one solution over the other.

Without a meaningful difference in the total equity allocation for a population of millennial participants, therefore, the difference in fees charged for TDFs versus MAs becomes even more of a factor when deciding between the two. We expect fees to vary depending on the level of service, investment philosophy chosen, and size of plan. With target date funds, the use of an underlying passive or active investment—or a combination of active and passive investments—will largely drive fees. For MAs, it is important to remember that there are fees in addition to the underlying investment manager fees that are used to construct a portfolio. The number and type of active or passive options offered in a plan lineup, as well as the investment methodology of the MA, can impact overall fees. Consider your plan's investment policy statement (IPS) and goals when selecting the appropriate QDIA. We would generally expect the all-in fee traditionally charged to a millennial to be lower for a TDF than for a MA, even when actively managed TDFs are offered.

#2 *How about near-retirees—which QDIA is best for this age cohort? We will consider factors such as: appropriate investment allocation to address sequence risk by mitigating significant losses near and in retirement; post-retirement strategies, including income or drawdown strategies, planning assistance and options; personalized assistance; transparency of investment methodology; and fees.*

MA provider: MAs are well-suited for near-retirees, as these investors often have the most diverse needs. Near-retirees must make a significant number of important decisions: how to invest, when to retire, whether to consider a delayed or “phased” retirement, when to take Social Security benefits, how best to withdraw from savings, etc. As a result, this cohort is likely to benefit from both the investment

and financial planning advice provided through a MA program. Additionally, the MA program can help near-retirees plan holistically, providing guidance on how to invest monies outside the plan. Members of this cohort typically have unique life circumstances, financial needs and resources outside the plan, and would particularly benefit from an opportunity to add such information to their overall financial picture under a MA program. Further, some managed account providers have built income programs that offer near-retirees a smooth transition from accumulation to benefit payments within the plan, helping to avoid costs associated with more expensive retail rollover accounts.

TDF provider: In focusing on delivering generally age-appropriate asset allocation at a reasonable cost, plan sponsors have overwhelmingly implemented TDFs as their plan's QDIA over other options for all age groups. Plan sponsors should understand how their participant demographics align with the assumptions made by target-date managers. Sponsors should consider the distribution of participants across age cohorts, as well as other key demographic features, such as savings behaviors and participants' outside savings. Ultimately, a plan sponsor can choose a TDF that best fits the overall demographics of the plan, while ensuring that its costs remain reasonable relative to the value participants derive from it. TDFs automatically manage asset allocation in an attempt to minimize drawdown risk at retirement. Some TDFs will also alter the underlying strategies to bring in more defensive asset classes to replace more aggressive ones. In post-retirement, it is simple for the TDF investor to begin periodic withdrawals of a certain dollar amount or a percentage of a portfolio, assuming the recordkeeper offers these options at a reasonable cost. What's more, these simple strategies can also be easily communicated to participants via traditional means of employee education.

Post-retirement decisions do involve several issues, and we believe participants will find comfort in having the investment aspect of that decision be a single investment option, one offering a fully diversified portfolio. While a TDF does not offer individual participants a personalized investment portfolio, it does offer them a simple, transparent portfolio based on generally accepted, age-appropriate investment strategies, at a compelling price. Importantly, near-retirees typically have the highest balances. As a result, the cost savings available through TDFs is often largest for these participants, resulting in a meaningful advantage for TDFs.

Investment Consultant Perspective: For investors nearing retirement—ages 55 to 65—the relative benefits of TDFs and MAs are becoming much more competitive. Historically, MA solutions have shown value by trying to solve for the different spending needs of participants—providing a range of asset allocation outcomes, Social Security sequencing advice and, potentially, annuity-purchasing advice. However, we are now also seeing TDF providers—traditionally

known for implementing a single, predetermined in-retirement asset allocation—trying to be more flexible by embedding allocations intended to gain access and exposure to guaranteed income in retirement from annuities pooling longevity risk.

In the final analysis, however, many MAs still provide more guidance on how to efficiently draw on assets from various sources in the retirement phase and can even take into account a spouse's or partner's assets. As a third option, plan sponsors should consider market innovations such as hybrid TDF/MA QDIAs. With these, the selected TDF automatically converts to a MA structure at a specified participant age or other demographic parameter selected by the sponsor. There are, however, many complexities to be weighed when evaluating the benefits of hybrid TDF/MA QDIAs.

#3 *All plan fees are paid by the plan participants. Which QDIA will ensure we offer reasonable total fees overall, while maximizing the value that the participants receive for those fees?*

MA provider: Cost is an important consideration when selecting the optimal default investment. Many MA providers offer lower pricing when the service is offered as the default, versus solely as an opt-in service. While many MAs typically cost more than TDFs, they are more than just an investment product; they can include personalized investment and savings advice, as well as communications that typically reach all participants—not just members of the managed accounts program. Additionally, MAs can be significantly less expensive than out-of-plan (i.e., retail) advice options, which are often offered by non-fiduciary advisors, with total expenses that can exceed 200 bps.

TDF provider: TDFs may offer a better value because they provide broad asset allocation based on the age of the participant for no additional fee. This is especially relevant given the fact that most participants are unengaged. Admittedly, there will be some participants who are willing to engage, and who have life circumstances for which a more customized approach may be appropriate; for those participants, an opt-in MA offering is a good solution.

Investment Consultant Perspective: When evaluating whether a QDIA's fees are reasonable, a Committee needs to balance its overall objectives with a comparison of the competitive market rate at which it can acquire each of the QDIA solutions. The comparison will be multi-faceted, since fees can differ from one TDF to another, and from one MA provider to another, let alone when comparing those of TDFs versus MAs. In general, when evaluating QDIAs there are two key factors that should be considered to ensure that a realistic like-for-like comparison is being made. Those two factors are: investment style—whether the product employs active or passive management, or a combination of both; and scale, or how a plan's overall size may impact pricing.

Investment Style

One of the largest differences in total fees charged stems from how a QDIA provider decides to implement an asset class: actively or passively. It is important for the Committee to distinguish whether the total fee savings is derived from an action the plan took (e.g., offering predominantly active or predominantly passive funds) or an action that the QDIA provider took (e.g., one related to how glide paths or portfolio construction models employ active and/or passive investments differently).

Scale

If a plan sponsor has a large pool of assets—one that affords its core lineup advantageous investment-manager fee schedules—and if the plan sponsor finds that weighted investment-management fees for projected portfolios in a MA solution are lower than those for a TDF suite with predominantly active underlying investment options, the sponsor should not attribute that fee advantage to the MA service provider. Instead, to ensure a fair apples-to-apples comparison, a plan sponsor should consider how the plan's advantageous fee schedule could be used by both QDIA providers.

Once there is a level playing field for comparing the potential costs of investment managers used to implement a portfolio, the Committee should evaluate what, if any, implicit cost the plan may incur by not utilizing a full array of available asset classes within a QDIA. This implicit "cost" comes in the form of lower potential risk-adjusted performance. For TDFs, we see this when comparing two similarly priced products offering very different asset allocations. For example, one TDF may offer exposure to commodities, while the other does not. Similarly, a MA provider is often limited by the investment options in a Committee-dictated lineup, and therefore may not have a full array of asset classes with which to optimize their portfolio construction approach. (Some Committees may make additional options available solely to the MA or custom-TDF provider, but this is not common, and may require an amendment to the Plan's investment policy statement.)

It's important for a Committee to know what asset classes are required to get the most value out of the MA provider's offering, and to then compare that to the asset classes available in the plan's own lineup. If there is a mismatch between what would allow that MA provider to optimize its investment model and the plan's lineup, then the expected risk-adjusted returns could be meaningfully different than initially projected. As investment professionals, we believe that differences in asset allocation, and the resulting impact on risk-adjusted returns, can meaningfully outweigh the small differences in investment management fees. Ultimately, there is an opportunity cost here that Committees should be sure to understand in terms of the possible impact it may have on participant outcomes, as its effect could be to lower potential returns.

#4 *What participant demographic inputs do the two QDIA providers need in order to offer an appropriate asset allocation model and portfolio construction?*

MA provider: Although data requirements are unique to each MA provider, common demographic variables used to determine the appropriate portfolio include: age, salary, balance, employee deferrals, employer contributions, state of residence, gender, loans, years of plan tenure, pension benefits, company stock balance, etc. MA providers can also incorporate additional data often provided by the participant, such as information about risk tolerance, out-of-plan assets, spousal information, health factors, etc.

TDF provider: TDF managers utilize a wide variety of average participant demographic data, either at the societal level for off-the-shelf TDFs, or at the plan sponsor level for custom TDFs.⁷ Once they have these, they can design, and continuously evolve, their product offerings. This participant data could include, but is not limited to: salary, plan account balance, employee deferrals, employer contributions, state of residence, gender, loans, years of plan tenure, pension benefits, company stock balance, etc. In addition, the distinct philosophies of various TDF providers offer choices to sponsors, who can then choose the asset allocation that best meets their plan's needs, given their specific demographics and preferences. Furthermore, many plans utilize a custom TDF, with the asset allocation then tailored to their specific plan. As a result, plan sponsors have many options to select from when choosing a TDF approach that best meets the needs of their participants.

Investment Consultant Perspective: Portfolio construction defines an investor's risk tolerance by evaluating the trade-offs of many things. Often, it is a trade-off between a time horizon (e.g., the investor's current age versus their retirement age or average life expectancy) and the investor's objectives (e.g., a supplemental savings account versus their exclusive source of retirement income). The two primary inputs that should be analyzed when selecting a QDIA are: 1) time horizon (how it's treated within an asset allocation process), and 2) risk budgeting. Directionally, we find that the longer the time horizon is, the more the risk-tolerance answer tends to suggest a higher capacity for risk-taking. We also find that the longer the time horizon is, the more risk a participant can typically bear; in that scenario, other demographic factors do not have as great an impact. As a participant's investment time horizon decreases, however, the impact of other demographic inputs such as gender, marital status, salary, current balance, deferral rate, etc., may have more of a pronounced impact, although they are still secondary to the time horizon. When evaluating these secondary factors, it is critical to understand how consistent and persistent they are in shaping the asset allocation of a TDF or MA provider.

Time Horizon

It's important that a Committee, when selecting a QDIA for either their entire participant population or a subset of it, try to define what it considers the time horizon should be for its plan as well as for the particular cohort. Is the time horizon, for instance, a normal retirement age such as age 65, or the estimated average life expectancy at age 90? When a Committee identifies the time horizon to which they are managing—e.g., “to retirement” or “through retirement”—they can then sequence their view on the meaningful impact that other demographic factors (such as marital status or dependents) will have on the plan's portfolio construction.

Risk Budgeting

Optimizing a risk budget over varying time horizons is critically important, and Committees should understand the factors driving a TDF or MA provider's risk-budgeting process. It's important to note that the selection of a TDF or a MA is not a point-in-time decision. The Committee needs to evaluate, on an ongoing basis, how their selected provider uses inputs to design their asset allocation. If, or when, the input assumptions change over time, the Committee should feel confident that the asset allocation output moved in the direction they expected, based on the change to the input.

ERISA Counsel Input: An ERISA Counsel provides three additional items that Committees might also consider, as they pertain to cybersecurity and data usage, both of which should be part of any QDIA evaluation and selection process.

First, with respect to cybersecurity, any time participant or plan information is delivered to a service provider, it is important to understand who gets the information, what processes are used to protect the information, the insurance and remedies for the plan in case of a breach, and how and when notice of breaches will be provided. For example, when data is being fed into TDF and MA programs, it is often put into third-party technology, which may not always be affiliated with a recordkeeper or consultant who already has agreements in place about security standards. Granted, sometimes existing contract provisions with a service provider already address these key security issues, because the third parties' contract with the service provider conforms to their standards. Sometimes, however, they do not. Therefore, looking “under the hood” with regard to these questions may help a Committee further document its prudent process.

Second, with respect to data usage, as QDIAs become more “personalized,” especially in the MA context, more individualized participant data may be shared with MA providers (after participant consent). At its core, a plan sponsor's understanding of the use—and potential limits on usage—of this data by the TDF or MA provider it has selected can be a positive part of procedural prudence.

Third, in 2013, the Department of Labor (DOL) issued a “tip sheet” on the selection of TDFs.⁸ Although this tip sheet is not binding, formal guidance from the DOL, it does provide additional helpful considerations that can be reviewed by a Committee, and with which a Committee should be familiar.

#5 *Getting our plan participants to engage is difficult. Which QDIA best uses the information we, as a plan sponsor, have to ensure the most appropriate asset allocation? How does each QDIA assist us as plan fiduciaries in getting our plan participants to engage?*

MA provider: Ten years ago, very limited information was automatically passed from the recordkeeper to the MA provider. Today, however, recordkeepers can generally supply MA providers with detailed information about participants. This data can be used to select a portfolio that is considerably more personalized than one based solely on the participant’s age (e.g., a target date fund). Additional information provided by the participant can further improve the initial recommendation. MA providers can automatically evaluate much of this “outside information” about participants, using data aggregation tools that weren’t as prominent 10 years ago. Furthermore, the introduction of a MA into a plan can offer an opportunity to re-engage participants who have been historically defaulted into a TDF with little or no engagement.

TDF provider: Most DC plan participants, especially those defaulted into a QDIA, by definition and practice do not engage. This lack of participant engagement is one of the primary reasons TDFs have been a successful QDIA for so many plan sponsors, since they are specifically designed for individuals who are defaulted into a plan and who, at the time of default, do not provide personal information, make decisions, and/or take action related to their DC savings and investment allocations. The TDF’s ease of use and understanding is key for these participants, who often have little to no financial knowledge.

Investment Consultant Perspective: Most participants stay enrolled at a plan’s established default rate and in the plan’s designated default investment, with the exception of participants who are approaching retirement within 10 to 15 years. The latter group is one in which we tend to see more variation from the defaulted savings rate and investment strategy.

It may, therefore, be important for the Committee to decide how closely engagement is related to retirement readiness, a common measure of plan success. For example, if a Committee agrees that the two biggest drivers of retirement readiness are dollars saved and the appropriate asset allocation, and that the majority of the plan’s participants remain disengaged, then perhaps the question for the Committee is, “Has the plan set the default saving rate as high as it

possibly can in order to improve savings rates?” Secondly, the Committee should consider the overall difference in QDIA providers’ base case asset allocation that is attributed to the data a plan is willing and able to automatically provide to the QDIA manager.

#6 *How might each QDIA improve participant retirement readiness?*

MA provider: There is a growing body of research demonstrating that MAs can improve participant outcomes (i.e., retirement readiness) both when used in an opt-out (i.e., default) framework and in an opt-in framework. While industry research is ahead of academic research, works of both types highlighting the positive impacts of MAs are featured in this paper’s Appendix, under “Further Reading.”

While the findings and respective sample populations differ across surveys, this body of research suggests that MA participants save more for retirement, have more appropriate portfolios, and are invested in portfolios that outperform other possible investment options—in many cases, even after considering the additional fees associated with the MA program.

TDF provider: With the popularity of TDFs serving as a QDIA (over 85% of sponsors utilize TDFs as the QDIA, according to Callan Institute’s 2017 Defined Contribution Trends Survey), there is continued recognition among plan sponsors of a TDF’s ability to improve participant retirement readiness. Numerous academic studies support the case for TDFs as a solution to improve retirement readiness; these studies can be found in the Appendix under “Further Reading.”

Most participants do not engage with their employer-sponsored retirement savings plan, and TDFs’ simplicity and low fees have been well received by many plan sponsors. A TDF provides a diversified, age-appropriate asset allocation—one that is rebalanced, professionally managed and, if it is a custom TDF, can contain core menu options, plus diversifying asset classes. For the large percentage of unengaged participants, baseline increased savings can be achieved simply and cost effectively via the auto features inherent in the QDIA selected (e.g., a match structure such as 50% of the first 10% deferred rather than 100% of the first 5%), including auto-enrollment (higher than 3%), and auto escalation (possibly above 10%). A significant percentage of the potential benefits of a MA structure relate to those participants who engage and save more as a result. Perhaps this should be evaluated relative to the baseline enabled through the auto features.

Investment Consultant Perspective: To answer this question, a Committee should assess the factors that they believe will most impact retirement readiness for their plan participants. Those factors often include savings, investment returns, and fees. Based on the collective answer to question #5, a Committee has the ability through auto enrollment and auto escalation to improve a plan’s savings rate

in a low-cost way or in a way that would gradually spread costs over multiple years. Both QDIAs can offer an efficient asset allocation before fees and therefore achieve generally reasonable risk-adjusted returns without significant distinction between them, as shown in the Appendix. That being the case, if the first two factors (savings and investment returns) are neutral, the crux of the comparison becomes the Committee's opinion of the relative difference in fees being charged for value produced: does one QDIA solution better align participants with a more appropriate net-of-fees asset allocation?

#7 *Our Committee struggles with how to benchmark investment options that are multi-asset class. How should we address our concerns of benchmarking investment performance when selecting a QDIA?*

MA provider: Plan sponsors should evaluate a MA program based on both its investment performance and its ability to help investors reach better outcomes (e.g., higher savings rates, more diversified portfolios, portfolio stickiness, retirement readiness, etc.). Focusing specifically on investments, the performance of the MA program is significantly influenced by the asset classes and quality of investments offered on the plan's core menu. Given the complexity involved, we suggest working with your MA provider to determine your plan's performance reporting needs and possible solutions. Importantly, investment performance alone does not fully capture the value of the MA service. For example, plan sponsors may want to consider benchmarking participant behavior (e.g., savings rates, maxing out the match) from a "before" and "after" perspective, or against industry averages.

TDF provider: When offering QDIAs, or any investment to participants, plan sponsors have a fiduciary responsibility to benchmark their selection. The TDF is sufficiently mature at this point for practices around appropriate benchmarking to have developed. For example, benchmarking of TDFs generally now includes an evaluation of risk-adjusted performance in comparison to:

- Custom-blended benchmarks that include a mix of passive indexes reflecting the asset classes used in the glide path
- Peer group comparisons
- Modeling realized, and potential outcomes of participants versus expectations
- Other product-specific factors.

Investment Consultant Perspective: We can measure expected risks and returns for both types of QDIAs if we have asset allocations at the individual portfolio level. Therefore, if we have the same individual asset allocation data, we can measure historical performance for

both TDFs and MAs. Each type of holding within the asset allocation will have its own benchmark, the same way a Committee benchmarks a similar investment within the core lineup. The absolute and relative return can then be totaled, based on the weighted average of the individual's asset allocation. This process will obviously be more time-intensive for a MA provider who has a portfolio for each individual than for a TDF provider that may have only 10 to 12 vintage portfolios.

While at the outset this process will be new for MAs, it's neither impossible nor uncommon. For example, multi-asset portfolios are measured every quarter for defined benefit (DB) plans, endowments and TDFs, so the methodology has precedent. Once the process to measure is in place, then a Committee should be able to attribute drivers of performance for both TDFs and MAs driven by risk taking, manager selection, or asset allocation decisions.

#8 *Which QDIA is best suited to handle volatile markets, particularly in severe negative market events?*

MA provider: Participants in MAs are more likely to remain invested during periods of volatility than those not in such accounts.⁹ Periods of market volatility often can prompt negative behavioral tendencies among participants, such as timing mistakes, which can take the form of re-allocating or withdrawing assets in reaction to market and political events. For example, during the volatility of the first quarter of 2020, one out of two participants who left a TDF dramatically reduced their equity allocation—signaling a fear of losing money but also unfortunately posing a risk for missing out when the market recovers.¹⁰ While the value-add from mitigating negative behavior could be up to 60 basis points for engaged MA participants, unengaged participants can also benefit from access to professional help, with savings up to 40 basis points.¹¹ Research has noted that default acceptance is higher for MAs than for TDFs,¹² and that participants in managed solutions trade their accounts less often,¹³ which could be important during volatile markets.

TDF provider: Relatively few participants in DC plans de-risk as a result of significantly negative market events, and the occurrence of de-risking is even lower for those utilizing professionally managed solutions, such as TDFs. For example, 98% of participants invested in a single TDF did not trade in 2016, despite the high level of market volatility in the early part of the year. In addition, the structure of TDFs allows for diversifying asset classes to help lessen downside risk in severe negative market events, as they have done for decades in endowments, foundations and DB portfolios. Most plan sponsors are unwilling to offer these diversifiers as stand-alone investments given liquidity, operational concerns and the fear that they will not be understood and used correctly by participants. Therefore, given that MAs are usually limited to what is offered on the core menu, they typically have access to fewer asset class exposures that can help limit losses in volatile markets.

Investment Consultant Perspective: The answer is, diversification. The QDIA provider that has a meaningful allocation to diversifiers will offer the solution that can best weather severe negative markets. As a Committee compares two TDFs, or two MAs, or compares a TDF and a MA, its members must understand: how does each investment solution make the decision to allocate to diversifiers, at what magnitude, at what point in a person's investment time horizon, and when would it shift its asset allocation or revisit its modeling assumptions (e.g., a 2 standard deviation event)? Answers to these questions can vary by provider. In order to prevent surprises, a Committee needs to feel confident that they understand the differences among providers before selecting a QDIA. The Committee should also document why they selected a certain provider.

#9 Which QDIA can assist us with our fiduciary obligations? Can we offload the fiduciary risks of offering a QDIA?

Fiduciaries often rely on the advice of investment consultants and ERISA counsel regarding fiduciary obligations. Therefore, the MA and TDF providers did not respond to this question.

Investment Consultant Perspective: No, a Committee cannot offload its fiduciary risks on either QDIA provider. For the most part, from an ERISA standard, both a TDF and a MA provider will be considered an ERISA 3(38) Investment Manager responsible for unlimited liability for their actions in selecting the asset allocation, as well as the investment they assign to that asset allocation. It is important for a Committee to understand what is actually stated in the investment management agreement for any investment manager it is considering hiring. Because some MA providers do not take on full ERISA 3(38) responsibility for all parts of the process (e.g., manager selection), a Committee could be assuming more fiduciary risk with one provider than with another. Therefore, it is important to review all agreements with your ERISA attorney before fully contracting with a provider.

ERISA Counsel: There is no one QDIA that absolves a Committee from fiduciary responsibilities. It is important to distinguish investments themselves from who makes the investment decision. As the investment consultant perspective highlights, a Committee can outsource some of its duties to a consultant or manager. There are two key things to keep in mind: (1) each "outsourcing" has different limits and conditions, so it is important to compare what each outsourcing vendor is, and is not, promising to own responsibility for; and (2) even if duties are outsourced, a Committee still has a duty to monitor the overall activities of the outsourced consultant or investment manager.

CONCLUSION

When selecting a QDIA, there are many variables to consider and a decision should not be made lightly. After reviewing the different points of view of providers, consultants and counsel, plan sponsors and their Committees will be well-positioned to make informed decisions when selecting or changing a plan's QDIA. DCIIA encourages plan sponsors to follow a prudent process when making any decision about investment options and plan design, and to rely on prudent experts, when warranted, for assistance. DCIIA hopes that plan sponsors will find this paper a helpful first step.

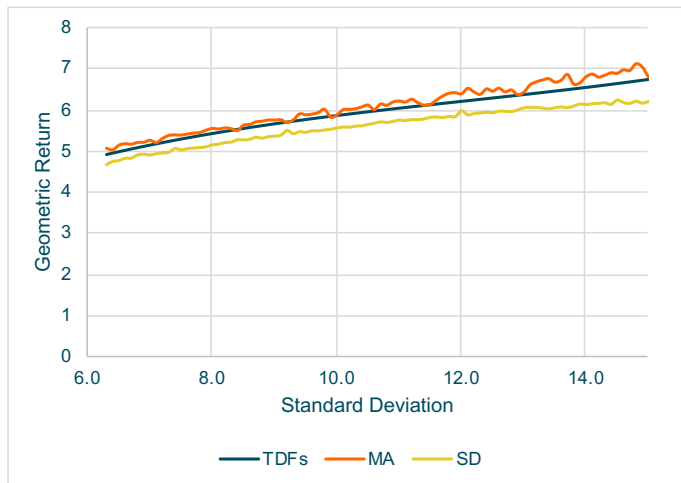
Endnotes

- ¹ Edelman Financial Engines Data Warehouse as of March 31, 2020.
- ² Hal Ernsner-Hersfield, G. Elliott Wimmer, and Brian Knutson, "Saving for the future self: neural measures of future self-continuity predict temporal discounting," *Social Cognitive and Affective Neuroscience*, November 30, 2008.
- ³ Vanguard 2019, "How America Saves 2019: The retirement savings behavior of 5 million participants," Vanguard, June 2019.
- ⁴ *Ibid.*
- ⁵ *Ibid.*
- ⁶ "2014 Defined Contribution Survey," and "2019 Defined Contribution Survey," PLANSPONSOR.
- ⁷ A custom target date fund allows the plan sponsor to select and control the underlying options in the target date funds, often from their plan menu, rather than using off-the-shelf target date funds.
- ⁸ US Department of Labor Employee Benefits Security Administration, "Target Date Retirement Funds – Tips For ERISA Plan Fiduciaries," February 2013. <https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf>
- ⁹ Brian Cosmano, "Made to Measure: Evaluating the impact of a retirement managed account," Great-West Investments, Empower Institute, June 2018.
- ¹⁰ Edelman Financial Engines Data Warehouse as of March 31, 2020. Published in client "Insights" June 2020.
- ¹¹ *Ibid.*
- ¹² David M. Blanchett, "The Impact of Managed Accounts on Participant Savings and Investment Decisions," Morningstar Investment Management, January 2019.
- ¹³ Vanguard 2019, "How America Saves 2019: The retirement savings behavior of 5 million participants," Vanguard, June 11, 2019.
- ¹⁴ *Ibid.*

APPENDIX

In the exhibit below we analyzed returns for participants investing in three different vehicles: a TDF, a MA, and a separately self-directed (SD) option in a plan's core lineup. The test used a set of standard forward-looking capital market assumptions to see the expected geometric return and volatility differences for these three investor types. Our observation: all three investor types managed to invest across the risk spectrum; those invested in one of the two QDIA choices invested 0.32% to 0.46% more efficiently than those self-directed investors using the core lineup. While this is a positive result, it also highlights the importance that a Committee should place on evaluating how a QDIA provider takes and budgets risk, as well as how its models or glide paths will adjust to changes in risk factors.

Average Expected Return for Various Portfolio Approaches by Risk Level¹⁴



FOR FURTHER READING

- “The Impact of Managed Accounts on Participant Savings and Investment Decisions,” by David M. Blanchett, Morningstar Investment Management, January 2019.
- “The Value of Managed Account Advice,” by Cynthia A. Pagliaro, Vanguard, September 2018.
- “Made to Measure: Evaluating the Impact of a Retirement Managed Account,” by Brian Cosmano, Great-West Investments, Empower Institute, June 2018.
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- “Target-Date Funds in 401(k) Retirement Plans,” by Olivia S. Mitchell and Stephen P. Utkus, The National Bureau of Economic Research, 2012.
- “The Efficiency of Sponsor and Participant Portfolio Choices in 401(k) Plans,” by Ning Tang, Olivia S. Mitchell, Gary R. Mottola and Stephen P. Utkus, The National Bureau of Economic Research, September 2009.
- “Winners and Losers: 401(K) Trading and Portfolio Performance,” by Takeshi Yamaguchi, Olivia S. Mitchell, Gary R. Mottola, and Steven P. Utkus, Pension Council Research Working Paper, Social Science Research Network, June 2007.

ABOUT DCIIA

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