

Core: What is it good for?



The role of asset class funds in today's DC plans, and a three-step process for improving the fund menu

Russell Investments Research



In today's defined contribution (DC) plan marketplace, we are seeing a significant increase in target date funds (TDFs) being used as the primary investment vehicle for plan participants. The growth has been rapid over the last 15 years; while TDFs were included in only 13% of DC plans in 2004, by year-end 2018 they were in 69% of plans¹. The average DC plan asset allocation to target date funds is 37%; more impressively, 59% of new dollars are flowing into these options, up from 22% in 2010².

Introduction

With target date funds playing an increasingly important role in the typical DC plan, many investment committees are looking more closely at their core fund menu. This is typically comprised of anywhere from six to 20 individual options and the bulk of the assets have historically resided in these funds. However, if the future lies in the plan's Qualified Default Investment Alternative (QDIA), it's reasonable to ask whether we still need a core menu, and if so, how many menus, and how should they be offered to participants?

This paper will first discuss the role of the core menu in DC plans of today and tomorrow. Then it will lay out a three-step plan we advise investment committees to consider as they migrate their asset-class options. Specifically, we recommend that plans:

1. Streamline the core menu
2. Utilize white-label funds
3. Implement multi-manager portfolios

Background: How we got here

There is a lot of nostalgia for the 1990s, and for good reason. The decade saw some great retirement plan industry innovations with the introduction of telephone voice response units, the exponential growth of the internet and the increases in small individual investors' ability to more easily manage their own portfolios, typically on a daily basis. In the matter of employer-sponsored DC plans, the decade also saw some bad menu designs.

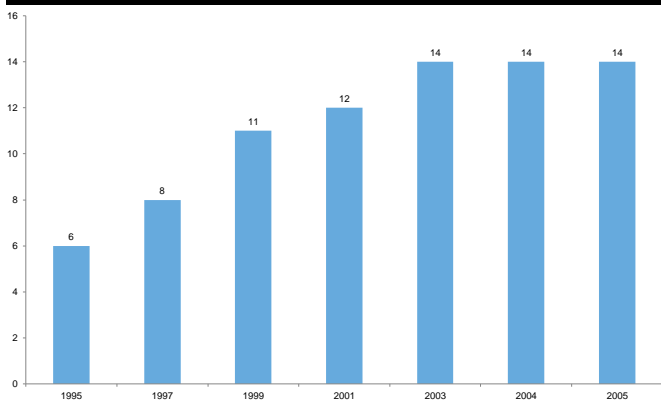
The DC plan innovations of the 1990s included increasingly user-friendly websites, daily valuation and – most germane to this paper – a surge in the number of large retail mutual funds available in plan menus. Retirement plan participants suddenly had investment options they could look up in newspapers and discuss at cocktail parties. Every style box was filled, narrow sector funds were offered, and in just 10 years the number of options the typical plan offered more than doubled, going from six in 1995 to 14 in 2005 (see Exhibit 1)³. Although the rate of increase has since slowed, there are some plans that still offer 20, 40, 60 or more options to participants.

¹ Source: Plan Sponsor Council of America's 62nd Annual Survey of Profit Sharing and 401(k) Plans, 2019, reflecting 2018 plan experience.

² Source: How America Saves 2020. A report on Vanguard 2019 defined contribution plan data.

³ Sources: Jeffrey R. Brown and Scott J. Weisbenner (2005), "401(k) Investment Options, Portfolio Choice and Retirement Wealth," University of Illinois at Urbana-Champaign and NBER; and Plan Sponsor Council of America's 55th Annual Survey of Profit Sharing and 401(k) Plans.

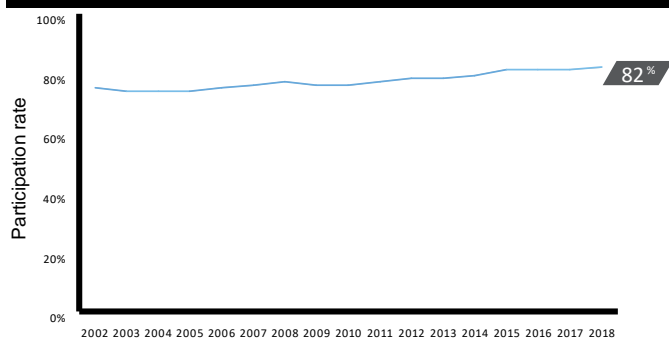
Exhibit 1: Average number of investment options



Source: Jeffrey R. Brown and Scott J. Weisbenner (2005), "401(k) Investment Options, Portfolio Choice and Retirement Wealth," University of Illinois at Urbana-Champaign and NBER; and Plan Sponsor Council of America's 55th Annual Survey of Profit Sharing and 401(k) Plans.

While these plans had a lot of "bells and whistles," it's unlikely they improved participant outcomes dramatically. In fact, they may have led to poor savings and flat participation rates (see Exhibit 2), lack of proper diversification and overall unwise investment behavior.

Exhibit 2: Average participation rate over time



Source: How America Saves 2019: A report on Vanguard 2018 defined contribution plan data, Vanguard.

Today, committees are realizing there must be a better way to offer investment options to their participants and they are ready to take back control of their plan menu. We call it the institutionalization of DC plans.

So, what does institutionalization mean? To us, it means focusing on smarter plan design, such as unbundling the fees paid for recordkeeping and investments. It means moving to more institutional-quality investment options and institutionally priced vehicles. It means less focus on brand name and single asset class and manager funds.

Laying the right foundation: The tiered menu design

Many committees have realized that every plan population has different types of investors with different needs, and we agree that it makes sense to offer a range of investment solutions for what we see as three broad categories of investors, whose styles we call "do it for me," "do it with me" and "do it myself." We advise investment committees to implement a plan design as depicted in Exhibit 3 to address the needs of these participants. The percentages in the exhibits express the approximate number of participants we find typically fall into each category.

On one extreme: You have... Tier 1—Do it for me

As with most things, the two extremes are easier to define and populate with the appropriate investment options, so let's start there.

At one extreme you have Tier 1 the "do it for me" investors. These participants want to hand over total control of their portfolio's asset allocation, as well as the portfolio's ongoing management and rebalancing, to an investment professional. We believe 60% to 80% of plan participants fall into this tier, and thus they should be the committee's primary focus.

Today, TDFs are the option of choice for participants in this tier, primarily because they are one of the most intuitive investment options available to investors. However, off-the-shelf TDFs are based on an average participant, rather than on specific investor characteristics, and they are only attempting to simplify investment decisions, rather than providing advice on funding and investing strategies. To improve outcomes for participants, investment committees might also consider offering managed accounts as the default option in Tier 1.

Managed accounts are a service for participants that recommend a savings level along with a personalized asset allocation using the core fund line-up. According to the Plan Sponsor Council of America's 62nd Annual Survey of Profit Sharing and 401(k) Plans, 9.2% of plans use managed accounts as their QDIA, with cost and platform availability as two factors likely creating headwinds for higher utilization.

On the other extreme: You have... Tier 3—Do it myself

At the other extreme is Tier 3, the "do it myself" investors. These participants want to take total control of and responsibility for their selections, asset allocation and the ongoing monitoring of their investments. We have found that satisfying the needs of this group while not overwhelming the other participants with too many choices in the plan menu is often a difficult balancing act for an investment committee. Brokerage windows are found in about 20% of plans and are

more common among larger plans with more participants⁴. If you decide to offer a brokerage window, it should give participants access to a full range of investment products as they build their asset allocations. Sponsors can also set a limit on the percentage of contributions participants can allocate to the brokerage window, to meet concerns that participants could take on too much risk when investing their assets.

In the middle: You have... Tier 2—Do it with me

So, what happens to the group between the two extremes? Every plan includes participants who choose to build their own portfolios out of funds selected for them by the investment committee. We call this group the “do it with me” investors. They are happy to let the investment committee determine the broad asset-class categories to offer; pick and oversee the managers; and leverage their buying power to allow for investment in institutionally priced solutions. The investment committee has played a critical role in winnowing down the choices amongst the available investment options. These participants then will use the investment menu as a foundation on which to build and monitor their own asset allocations. Combined with enhanced education, guidance and/or managed account solutions to provide asset allocation support, a well-built core line-up of “building block” funds can provide a good solution for Tier 2’s “do it with me” investors.

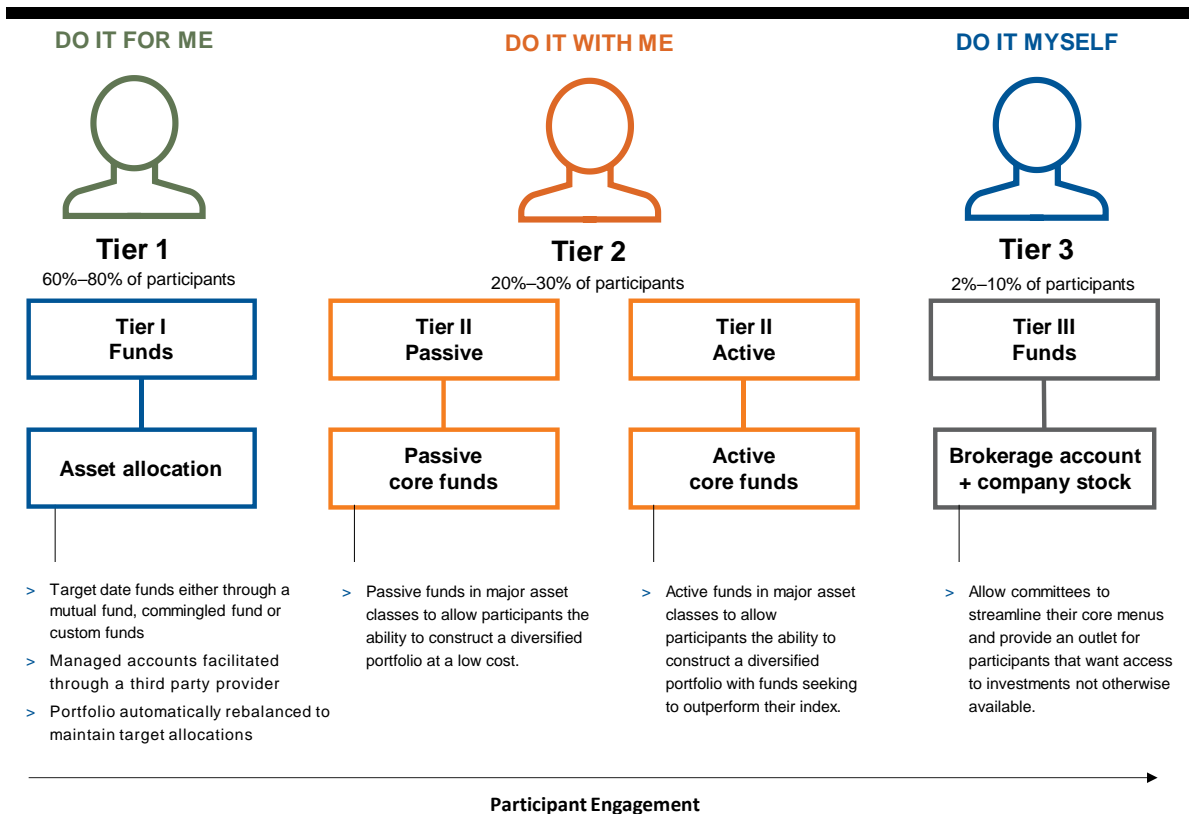
So now we understand that the core menu plays a critical role in supporting the institutional-quality building block funds. But, what should it look like? We suggest the following three-step process to building a core menu.

Step 1: Streamline the Tier 2 menu

Investment committees that still view DC plans as supplemental often emphasize choice over the quality or clarity of investments. However, as fewer employees are covered by a pension benefit, it becomes even more important to have a clear and well-designed core menu to improve the likelihood of successful retirement outcomes. Including both an active and a passive investing tier in a DC plan, in an effort to accommodate the needs of a majority of employees, is a reasonable approach. However, the distinction between the tiers must be communicated so as to not overwhelm participants with too many highly correlated investment choices.

Russell Investments has established a baseline investment structure for Tier 2 that includes an active and passive mirror for the core menu. The objective is to simplify participant investment decisions, maintain economies of scale with plan assets invested in fewer options and accommodate the investment needs of a majority of participants. Our model Tier 2 asset class line-up looks something like what is shown in Exhibit 4:

Exhibit 3: Your plan design drives participant behavior



⁴ Source: Plan Sponsor Council of America’s 62nd Annual Survey of Profit Sharing and 401(k) Plans, 2019, reflecting 2018 plan experience

Exhibit 4: Example of a Tier 2 menu

TIER 2 – PASSIVE	TIER 2 – ACTIVE
International Equity	International Equity
U.S. Small Cap Equity	U.S. Small Cap Equity
U.S. Large Cap Equity	U.S. Large Cap Equity
Core Fixed Income	Core/Plus Fixed Income
	Capital Preservation

Think outside the box

This is only a starting point, and there are variations on the theme based on plan history, plan participant characteristics and investment committee beliefs and objectives. But we employ certain key tenets and themes to determine an appropriate line-up.

For one, options should span the risk/return spectrum and be distinct from each other. Far too many of the plans we have seen are overweight U.S. equity funds. Although these fund options represent different style boxes, they are all U.S. equity funds and thus are highly correlated to each other over the long term, as can be seen in Exhibit 5. And the result? Some participants allocate an equal percentage to each option in the menu but still end up with poorly diversified portfolios.⁵

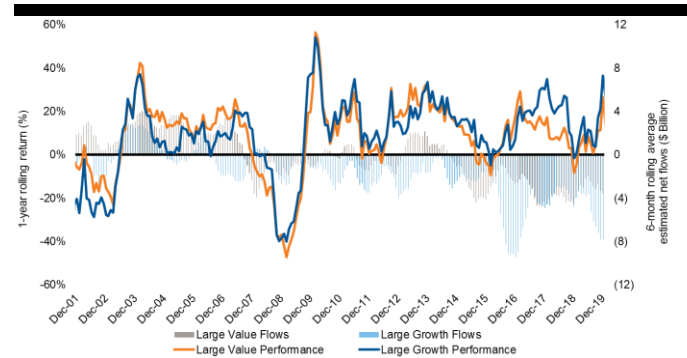
Exhibit 5: 10-year U.S. equity correlations as of June 30, 2020

	LARGE BLEND	LARGE GROWTH	LARGE VALUE	MID-CAP BLEND	MID-CAP GROWTH	MID-CAP VALUE	SMALL BLEND	SMALL GROWTH	SMALL VALUE
LARGE BLEND	1.00								
LARGE GROWTH	0.97	1.00							
LARGE VALUE	0.99	0.92	1.00						
MID-CAP BLEND	0.98	0.94	0.97	1.00					
MID-CAP GROWTH	0.96	0.97	0.92	1.00	1.00				
MID-CAP VALUE	0.97	0.91	0.98	0.97	0.94	1.00			
SMALL BLEND	0.94	0.89	0.94	0.99	0.95	0.98	1.00		
SMALL GROWTH	0.92	0.93	0.90	0.98	0.98	0.93	0.97	1.00	
SMALL VALUE	0.92	0.86	0.94	0.96	0.91	0.98	0.99	0.94	1.00

Source: Morningstar Direct. The proxy used to calculate are Morningstar Open End Fund Category Averages.

We believe investment committees should move away from building menus around style boxes and instead collapse growth and value funds into broader, multi-style core mandates. The recognition of growth and value styles of management is important when evaluating manager skill, but the typical DC plan participant doesn't understand the differences. In fact, we believe participants are likely to buy and sell between growth and value at precisely the wrong times. Exhibit 6 illustrates how flows into growth and value funds tend to follow performance increases and decreases.

Exhibit 6: Typical investors have struggled in timing investments



Large growth and large value flows are based on Morningstar Open End fund category estimated flows. Performance is based on the Russell 1000® Growth and the Russell 1000® Value indexes.

⁵ Source: Shlomo Benartzi and Richard H. Thaler (2001). "Naive Diversification Strategies in Defined Contribution Savings Plans."

American Economic Review, Vol. 91.1, pp. 79–98. Available to AEA subscribers at <http://www.aeaweb.org/>.

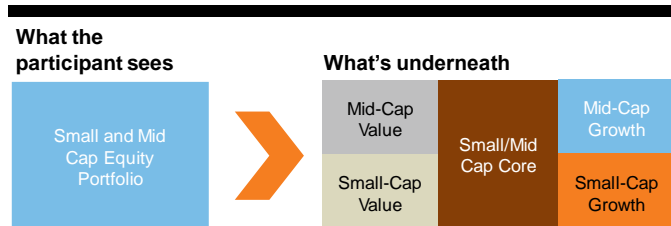
In addition to collapsing style and other overlapping options, we recommend that investment committees reconsider their decision to offer narrow-sector funds or asset classes that are highly volatile. For example, Emerging Market Equities is an important asset class that is often missing from plan menus. However, instead of offering it as a standalone option, we believe a better solution would be to offer portfolios with a broader opportunity set that includes exposure to both developed and emerging market international equities.

Step 2: Utilize white-label funds

In the past, the traditional retail mindset drove menus, and communication with plan participants used the retail brand name given by the fund provider. However, while it's true that many participants will recognize brand names, if a fund is called "Constellation" or "Frontier," or is named for a 16th-century explorer, will participants understand the role it is intended to play in an investment allocation? When you streamline your plan menu by using white label funds, you can move away from the traditional marketing technique of selling on brand name.

With that in mind, what names *should* we use? A good start is just to describe the asset class. Naming will be cleaner, less ambiguous and, hopefully, more consistent from plan to plan. While not perfect, we think this convention gives the "do it with me" investor a better chance to understand the fund's investment strategy and to allocate appropriately to it in their retirement plan portfolio.

Exhibit 7: Simplifying Participant Investment Decisions



For illustrative purposes only.

White label portfolios are often able to use separate accounts and other more institutionally priced vehicles offered by managers to reduce investment expense. Combining active and passive strategies is another effective way to balance cost with excess return potential. The amount of passive management is typically driven by two primary factors – fees and market efficiency.

White labeling also provides a benefit to the investment committee and plan sponsor. It becomes much easier for a committee to make a manager change in this structure. There may be less attachment to a fund when a brand name is not used for promotion. We've seen many committee members struggle to remove well-known, brand-named funds that are no longer meeting their criteria because they worry about participant reactions, which is a worry that typically proves unfounded. Using a white label approach removes this concern and makes manager changes less disruptive. In fact, this approach often reduces the need for participant

communications and other related administrative burdens associated with a manager change.

To be clear, this does not lead to a lack of transparency for participants. You will provide the investment fund(s) that make up the white labeled options, and you can give participants as much detail as you like about those options. However, this is about leading with a name that is more generic than the fund provider's name. We also hear the argument that participants want to be able to "look up the fund in the newspaper" or through an online source. Regardless, there is little anecdotal evidence that the typical participant wants this. And, on most plan websites today, participants can get a great deal of information on the investment options, just as they would with retail funds. For those who want more, retail funds can be accessed via the Tier 3 brokerage window.

It's often difficult for participants to construct a portfolio when they are confronted with too many choices. That's why we believe plans should move their streamlined core options to a white label, multi-manager structure.

Step 3: Implement multi-manager portfolios

Collapsing and consolidating options doesn't mean you need to remove diversification. As a plan fiduciary, you may like the large cap growth, core and value funds in your plan, and participants would certainly benefit from both the opportunity to diversify and access to quality managers with different investment styles. But, as we suggested in Step 1, it's often difficult for participants to construct a portfolio when they are confronted with too many choices. That's why we believe plans should move their streamlined core options to a white label, multi-manager structure.

There are many benefits to a multi-manager structure. To start, style diversification, as mentioned previously, can provide great benefits. In addition to growth and value, other factors and styles (e.g., momentum, deep value, quality, volatility, active, passive, quantitative and fundamental) go through different cycles and are in and out of favor at different times. Managers focus on different areas of the market, and diversifying among managers within one solution can provide a smoother ride for plan participants.

Further, even though you may have a disciplined process for picking strong managers, things don't always work out as planned. Key portfolio managers leave; organizations change; strategies run out of capacity; or promising managers sometimes just don't live up to expectations. Exposing your participants to the idiosyncratic risk of a single manager is best avoided by building a best-of-breed multi-manager solution. We believe it is the only way to diversify away single-manager risk.

Exhibit 8: Expected distribution of returns

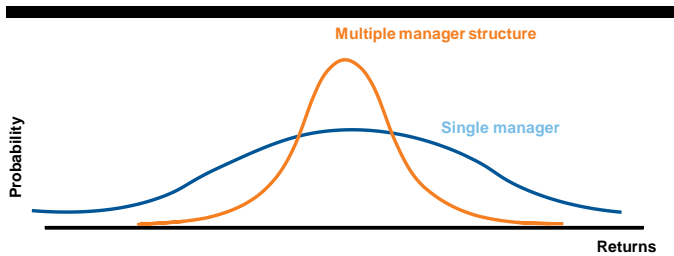


Image shown for illustrative purposes only and is not meant to represent any actual results.

Finally, a multi-manager structure makes it much easier and less disruptive to part ways with a manager you no longer want in your white label fund. You don't need to pull out a whole investment option and start over. You can just remove and replace managers within the structure.

Multi-manager, multi-style investing is not a new idea. It's the way institutional investors, such as defined benefit (DB) plans, have been investing for decades. DB plans would never invest all their assets with one underlying investment manager – especially across asset classes, but not even within asset classes. Thus, multi-manager/multi-style is another example of how to institutionalize a DC plan.

Moving to this approach may seem daunting, and you may well be asking how it is done. Some larger plans with the requisite expertise, scale and resources (including those with experience in doing this for a DB plan) are building their own multi-manager funds. There are unique challenges to building a multi-manager structure, particularly in the initial setups, but many plans have already been doing this for years, so it is operationally feasible⁶. For investment committees that aren't inclined to do this themselves, off-the-shelf multi-manager solutions are available. Manager selection and portfolio construction can be effectively outsourced to a third-party expert.

Conclusion

We believe that menu design plays a very important role in the success of a plan. For committees seeking to engage participants and help them achieve better retirement outcomes, consolidating and simplifying the plan menu is a good first step. For most participants, finding the right investment strategy is not an easy task. Over the years, committees have learned that not all plan design enhancements lead to better participant choices. Some may even result in a more complex decision-making process.

The key is to design an understandable menu that guides participants toward making appropriate choices. Remember, better investment decisions can lead to better retirement outcomes. So, think about the framework of your plan menu with the following three steps in mind:

⁶ For more information, please see “Q&A: Redesigning your plan's core menu”. *Russell Investments*.

1. Offer a small menu of core multi-strategy mandates
2. Give the funds descriptive names that help participants readily understand their intended uses in a portfolio
3. Construct those mandates from the strategies offered by the best managers available

We feel strongly, on the basis of our extensive experience in working with committees, that this approach can build a solid institutional foundation that can benefit participants as they strive to meet their retirement goals, and committee objectives as well, as they strive to fulfill their fiduciary responsibilities.

For some additional insights into this approach

Please see our companion piece, “Q&A: Redesigning your plan's core menu”, which is available on [RussellInvestments.com](https://www.russellinvestments.com). The 10 questions addressed are:

1. Why offer a tier of asset class options at all? Why not offer a plan design that consists solely of target date funds and a brokerage window?
2. Why offer as many as six to 10 options on a core menu? Aren't two or three enough?
3. I have more than 20 options available today. Collapsing that menu down to six options seem drastic. What should I do?
4. You suggested using the asset-class names for the white-labeling. But do participants really understand what these names mean?
5. Do I need to implement all three steps at the same time?
6. What about active and passive investing tiers? Should I offer both in my plan?
7. From an operational standpoint, isn't moving to a white-labeled and/or multi-manager structure a headache?
8. With more custom solutions, aren't participant communications more difficult?
9. Wow, this sounds like a lot more fiduciary risk. Isn't it less of a risk to pick an off-the-shelf mutual fund?
10. How do I report performance on these types of solutions?

For more information

Call Russell Investments at [800-426-8506](tel:800-426-8506) or visit russellinvestments.com/institutional

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