Innovations in the Defined Contribution Market

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INTRODUCTION

Building upon our previous analysis of the U.S. retirement market, we continue to take a closer look at the opportunities and challenges facing professionals in the defined contribution (DC) marketplace.

Together with Strategic Insight, we are releasing a series of short industry briefs in which we discuss specific key trends, themes, obstacles and opportunities for asset managers currently (or planning on) participating in the U.S. retirement marketplace. While the initial piece in this series, "The Defined Contribution Market Meets Its Match," focused on the capabilities and benefits of collective investment trusts, this paper will address and highlight additional innovations that have had an impact over the last decade, as well as those that will help shape the DC market moving forward.

THE DEFINED CONTRIBUTION MARKET OPPORTUNITY

Since the bear-market low in the first quarter of 2009, DC assets have more than doubled from $3.4 trillion to $7.0 trillion at year-end 2016—currently accounting for 28% of the overall retirement market.

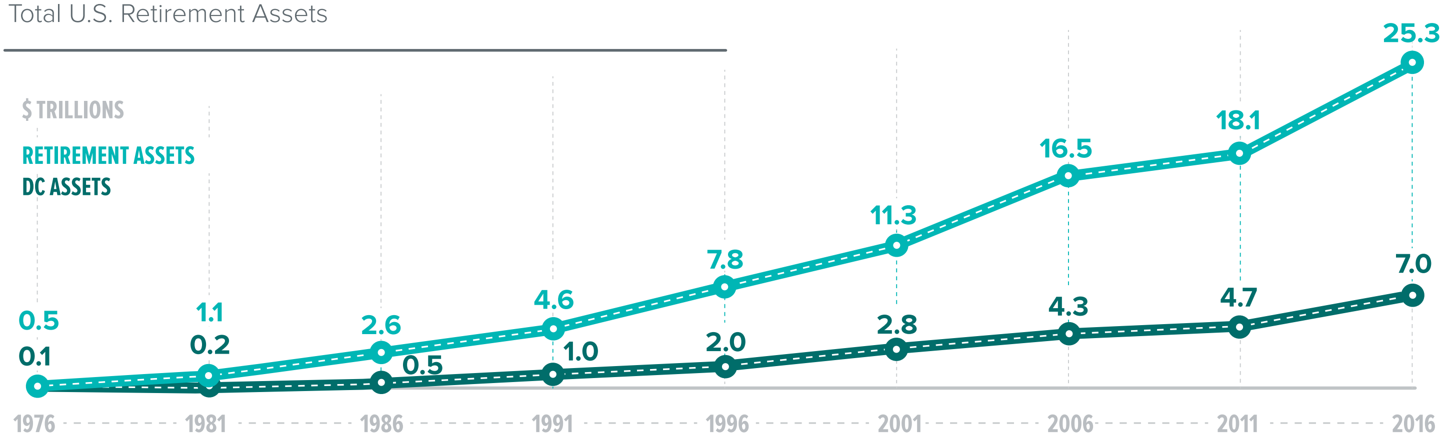
As the responsibility for funding retirement has largely transitioned away from employer-funded defined benefit (DB) plans and landed squarely in the hands of individual employees, the market share of DB plans as a whole (private-sector, federal, state and local government) has been cut in half over the last 40 years (33% in 2016 vs. 67% in 1976).

Over this same period, individual retirement accounts (IRAs) have grown from virtually nothing to a 31% share of the retirement market—surpassing DC plan assets in 2007. Unsurprisingly, much of the growth in IRA assets and market share has come in the form of rollovers from employer-sponsored DC plans. Whether due to issues with vehicle portability between plans, efforts to consolidate assets, or a desire for additional investment products, participants exiting plans and rolling assets to individual accounts consistently represents 95% of inflows for traditional IRAs.

INNOVATION IN AN EVER-CHANGING MARKET

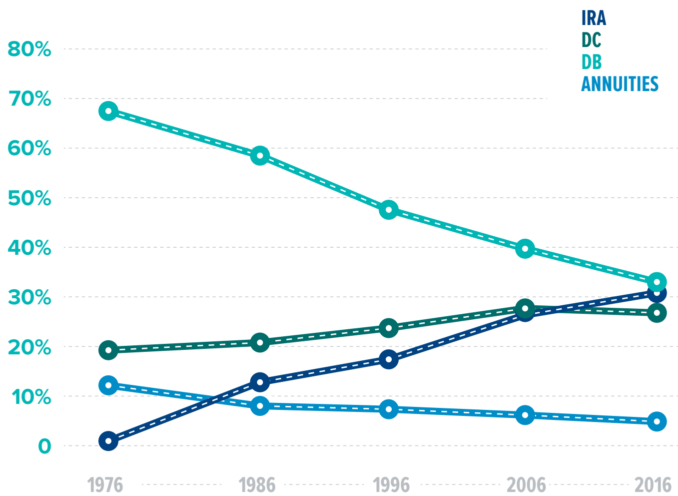
In the DC market, where individual accountability for accumulating retirement wealth is high, asset managers, advisors, plan sponsors and legislators continue to develop, seek out and pave the way for new and innovative approaches to aid participants in meeting their goals. From the use of asset allocation funds—target date and target risk included—to the Pension Protection Act of 2006 (PPA) and the safe harbors it affords, increasing participant diversification and exposure to a variety of asset classes has been a focus for the last decade. Recently, these themes have been expanded as target date funds (TDFs) continue to evolve, pricing trends focus on simplicity and advice models embrace emerging technologies.

FIGURE 1
Total U.S. Retirement Assets



Source: Investment Company Institute.

FIGURE 2
Historical Share of U.S. Retirement Market

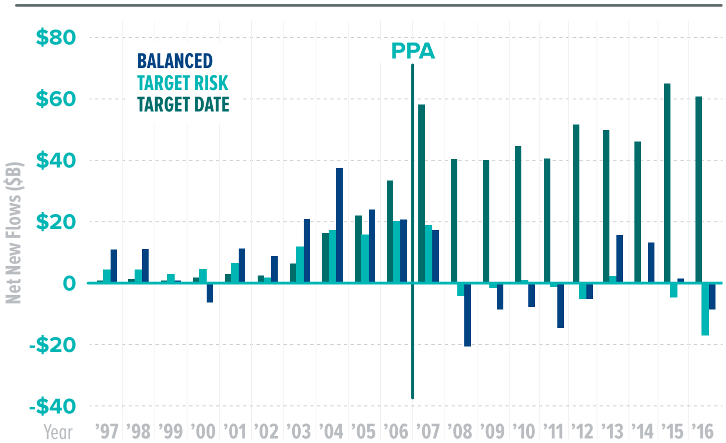


Source: Investment Company Institute.

TARGET DATE FUNDS HAVE SEEN CONSIDERABLE GROWTH

While the PPA cleared the way for plan features such as auto-enrollment and auto-escalation as a means to urge eligible participants into plans (and to do so at higher contribution levels), it also set the stage for TDFs to become the default investment of choice for the industry. Even as balanced funds and managed accounts fit the mold as qualified default investment alternatives (QDIAs), simplicity, cost and a well-crafted marketing narrative have led to unmatched flows into TDFs over the last 10 years.

FIGURE 3
Annual Net New Flows: Target Date, Target Risk and Balanced Mutual Funds



Source: Strategic Insight.

As illustrated in Figure 3, before the passage of the PPA in August 2006, flows into Balanced Funds, Target Risk Funds (a subset of Balanced) and TDFs, were all generally on the same trajectory. Post-PPA, it can be clearly seen which QDIA has become the vehicle of choice. It is important to note that not all of the assets in these products are held in employer-sponsored DC plans. Figures from the Investment Company Institute, for example, estimate that at the end of 2016, 67% of TDF mutual fund assets were held in plans, with another 20% in IRAs.

The primary driver behind the strong flows that TDFs have seen recently is evidenced in *PLANSPONSOR* magazine's annual survey of more than 4,200 DC plans of varying sizes and industries. The 2016 study found that of the 42% of plan sponsor respondents with auto-enrollment features in their plan, 66% use some form of TDFs as a QDIA for these purposes. The majority of these plans offer retail off-the-shelf products, but custom solutions are now available in 10% of plans surveyed.

FIGURE 4
Default Investment for Auto-enrollment

Source: *PLANSPONSOR* and Strategic Insight.

Though the success of TDFs has been clear, the market is still dominated by the top players in which 72% of mutual fund assets in the products were held by the top three managers at the end of March 2017. The combined market share of Vanguard, Fidelity, and T. Rowe Price is down from 84% for the same period 10 years prior, but this entrenchment has forced new entrants to fundamentally differentiate their offerings from the established players.

TARGET DATE FUNDS HAVE EVOLVED

To compete as a TDF manager today, it is extremely difficult to bring a conventional, proprietary fund-based series to market and expect to make significant inroads. Historical means of differentiation—such as active vs. passive, "to retirement" vs. "through retirement," and glidepath equity allocations—are simply not enough to bring attention to a series. Though results have yet to be seen, recent launches and alterations to existing TDF series have included features such as multi-manager composition, smart beta, real assets and socially conscious investments.

In today's environment of increased transparency, the move to unaffiliated and mixed multi-manager fund-of-funds models in TDFs is, in one way, the retail market's response to the historically institutional, consultant-driven, custom TDF options available primarily to large and mega plans. The aim in both cases is to use best-in-class investments to construct optimal portfolios, while lowering costs and easing certain administrative functions such as switching sub-advisors in and out of the products. Even as 98% of TDF mutual fund assets reside in products with affiliated underlying funds, several series have launched since the start of 2016 that fit the multi-manager model, including options from Natixis, Goldman Sachs and AXA.

Another theme with limited presence, but significant potential in this area, is the inclusion of socially conscious investments in TDF strategies. Whether referred to as environmental, social and governance (ESG), socially responsible investing (SRI) or impact investing, this type of strategy aims to reflect investors' moral and ethical values through specifically screened investments. Even with the general popularity of the concept, the presence of socially conscious investments in retirement plans as a whole has been fairly limited, occupying less than a 1% share of the DC mutual fund market, according to 2014 DC plan data from BrightScope, a Strategic Insight subsidiary. This market share is on par with the mutual fund industry as a whole, with socially conscious funds representing 1.3% ($199 billion) of fund assets at the end of Q1 2017.

Even as relatively few managers have embraced this theme of values-based selection, during the first quarter of 2017, Natixis launched the industry's first broad-based ESG-focused target date offering with its Sustainable Future series. Natixis joins managers such as GuideStone, American Century and American Funds, who all currently incorporate various degrees of social responsibility into their TDFs (see Figure 5).

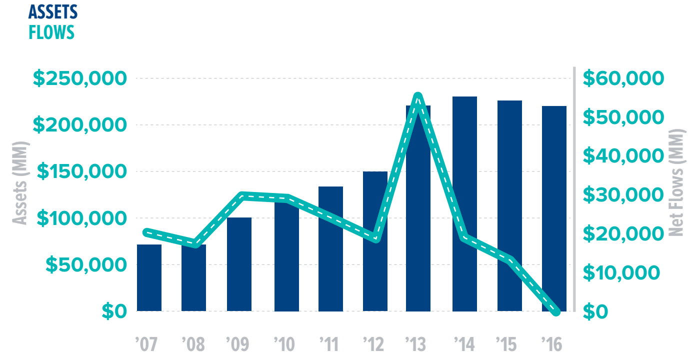
FIGURE 5
Socially Conscious Strategies in Target Date Funds

TDF Manager	Socially Conscious Strategy	Total TDF Assets Q1 2017
American Century	More than 75% of series assets invested in the firm's 'No Tobacco' funds	$18.0 billion
American Funds	Use the firm's Washington Mutual fund (excludes alcohol and tobacco) throughout the series	$62.4 billion
GuideStone	Faith-based	$2.5 billion
Natixis	Broad-based	$27.2 million

ALTERNATIVES AND REAL ASSETS STILL HAVE A PLACE

Across the broader mutual fund industry, flows into liquid alternative funds have tapered over the last three calendar years, with assets remaining generally flat since 2014 (Figure 6). Yet, this has not stopped managers from exploring ways to incorporate these types of investments within DC plan lineups. With only 5% of plan sponsor respondents in *PLANSPONSOR* magazine's previously cited annual survey offering alternatives as stand-alone options on fund menus, a logical placement for such strategies is within TDFs. The use of real estate investment trusts (REITs) and commodity funds inside TDFs has been common for some time now, with 65% and 40% of series holding these categories, respectively, at the end of 2016.

FIGURE 6
Liquid Alternative Fund Assets Flows



Source: Strategic Insight.

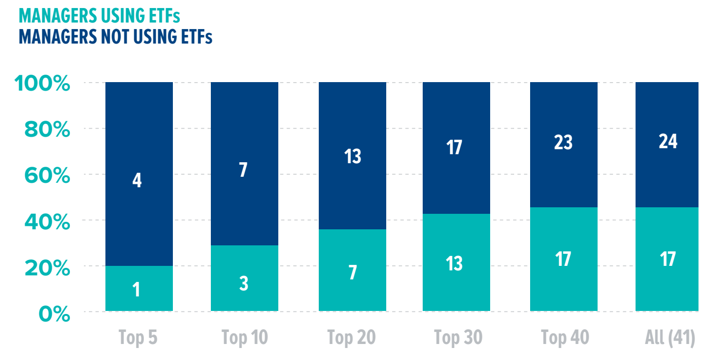
For underlying funds fitting the “Alternative” category, only seven TDF providers included such options at year-end 2016, with multi-alternative funds being the investment of choice due to their broad coverage of the group. Until recently, no providers have used direct real estate in the mutual fund versions of their TDFs. Stepping out from the pack, TIAA began adding direct real estate holdings to its Lifecycle TDF series though an affiliated real estate investment firm during the middle of 2016. The funds’ management team is targeting a 5% allocation to these investments as a means of diversifying the portfolios and reducing volatility due to the lower correlation to stocks than REITs.

IS THERE ROOM FOR EXCHANGE-TRADED PRODUCTS?

Across the DC market as a whole, exchange-traded funds (ETFs) have yet to take hold as they face fairly significant barriers to acceptance as stand-alone investment options on plan lineups. With limited exceptions, established recordkeeping platforms are, for the most part, not technologically capable of accommodating the intraday pricing and trading associated with the products, and the tax advantages linked to ETFs are largely nullified with the qualified nature of DC plans. ETF availability at this point is limited mainly to self-directed brokerage windows rather than as core menu options.

But this does not mean that there is no place for the vehicles within retirement plan lineups. Facing considerable pressure to both contain costs and manage capacity, many TDF managers have incorporated index funds as a means to achieve those objectives. Other managers, particularly those newer to the TDF market or on the smaller end of the spectrum, have turned to ETFs to meet their indexing needs. Without proprietary index mutual funds at their disposal, these managers are using ETFs as core portfolio building-blocks (Large Blend, Intermediate-Term Bond, Foreign Large Blend) in an effort to compete with the scale of larger, more established managers.

FIGURE 7
ETFs in TDFs—ETFs in Top 10 Holdings of TDF Managers by Size



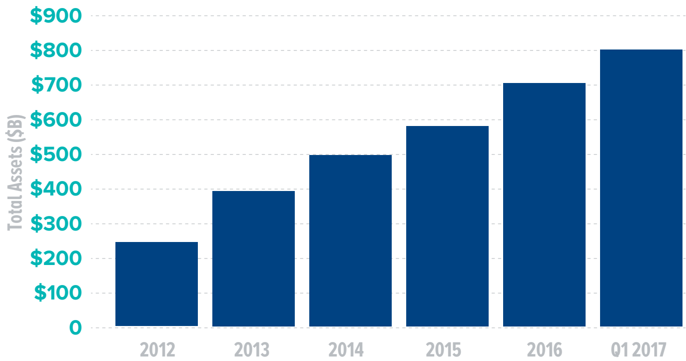
All U.S. mutual funds and ETFs in Morningstar’s “Alternative” categories.
Source: Strategic Insight.

While their viability in the DC market is likely subject to the same headwinds as ETFs, the recent introduction of exchange-traded managed funds (ETMFs) can be seen as an attempt by managers of active mutual funds to hold their ground in the battle against their passive rivals. This lower-cost packaging option, introduced early last year under the NextShares brand-name may aid in narrowing the pricing gap between active and passive investment options. Put simply, these products are structurally a hybrid of mutual funds and ETFs. Also, they combine the protection of confidential portfolio and trading information—holdings are released monthly or quarterly similar to mutual funds—with the cost- and tax-efficiencies associated with trading on an exchange.

PREPARE FOR PRICING FOR A NEW AGE

As the industry approaches the extended implementation date for the Department of Labor (DOL) fiduciary rule, asset managers and those providing advice are preparing for a change in landscape. As advisory fee structures have been evolving over the last few years, interest in bare-bones share classes has risen significantly, with an increasing number of managers adding these products to their lineups. As of the end of Q1 2017, 66 managers offered such zero/zero share options—share classes, such as R6, without embedded revenue sharing, service or distribution expenses. Assets in this type of share class have risen to $807 billion with a five-year compound annual growth rate of 30% for the period ending March 31, 2017 (Figure 8).

FIGURE 8
Zero/Zero Mutual Fund Asset Growth



Source: Strategic Insight.

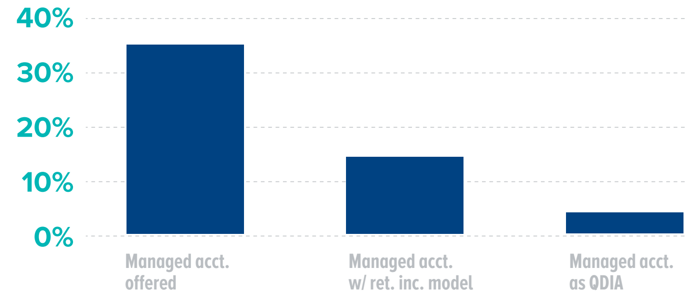
Historically, these share classes have largely been offered solely to employer-sponsored retirement plans; however, due to their appeal, managers have shown a willingness to broaden eligibility to include other institutional investors such as endowments and foundations. Taking this a step further, several firms, including American Funds, American Century, Cohen & Steers, Lord Abbett, and Franklin Templeton (among others) have either recently launched (or have indicated their intention to launch) zero/zero share classes available to retail wealth management clients through fee-based platforms. These launches will extend the advantages, consistency and transparency of such share classes to individual investors and their advisors.

THE ROLE OF MANAGED ACCOUNTS AND RETIREMENT INCOME

According to Callan's most recent DC Trends report, almost 36% of plans surveyed offered managed account programs to their participants, though only 2.5% used the option as the plan's QDIA in 2016. Additionally, half of the 165 sponsors surveyed offered retirement income solutions to participants, with 14% of sponsors offering managed accounts with drawdown modeling services as a means of meeting retirement income needs. This managed account drawdown option was second only to providing access to an affiliated DB plan (27%) as a retirement income option. In-plan annuities have yet to gain popularity with only 4% of plans offering the products.

While independent providers such as Financial Engines and Morningstar lead the pack in terms of discretionary assets under management, proprietary programs run by recordkeepers, such as Fidelity and Empower, have a natural advantage when working with plans on their own platforms. It was recently announced that Fidelity has begun establishing alliances with other recordkeepers in an effort to establish shelf space for the firm's Portfolio Advisory Service at Work (PAS-W) managed account product on these external platforms. This strategy could certainly prove successful with smaller providers, though it will surely be a much tougher sell with their primary competitors.

FIGURE 9
Managed Account Offerings in DC Plans



Source: Callan Associates, 2017 DC Trends.

As previously discussed, managed accounts have faced challenges in gaining share as QDIAs thus far, partially due to perception related to the costs of the products as compared to TDFs. The primary advantage that managed accounts possess over TDFs is the ability to factor in multiple data points when assigning an allocation rather than just the age of a participant. However, in this current litigious environment, when sponsors and advisors consider cost alone when constructing plan investments and options, an indexed TDF series will always provide the best optics.

EFFICIENCY AND FLEXIBILITY ARE ESSENTIAL

The past decade has been one of great progress and growth for the DC marketplace. Alongside its rising asset levels, the industry's self-awareness has risen to help drive developments targeted at bolstering an environment not only beneficial to plan sponsors, but with a greater focus on participant interests as well. Auto-features, allocation models, broader exposure to esoteric asset classes, and values-driven investing have all affected the way that DC plan menus are currently constructed and we expect this trend to continue over the next decade. The industry is at a point in time where greater efficiencies and flexibility are essential to the success of investment managers. Also, as the regulatory environment works itself out, players in the DC market will continue to be faced with questions regarding product development, pricing and strategic alliances. As speculation of industry consolidation swirls and innovation accelerates, those firms that fail to adapt to the new normal may find themselves on the outside looking in.

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