The Case for Rethinking TDFs as QDIA
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and Mike McKeown, Director of Research at Aurum Advisory Services
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Overview of QDIA Landscape
A Quick Look Back

- Pension Protection Act of 2006
- Importance of QDIAs
- Why TDFs?
Organic Growth Rate by Year

Annual Growth Rate (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>76%</td>
<td>24%</td>
<td>30%</td>
<td>19%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Organic Growth Rate by Strategy

Available 5 years ago with a 3-year track record
Proliferation of Product

Available 3 years ago with a 3-year track record

Proliferation of Product

Available today with a 3-year track record

Market Dominance

Where Are We Today?

Current Trends

Fee Awareness
- 408(b)(2) & 404(a)(5)
- Index Funds & ETFs
- Transparency

Fund Choice
- Lost Decade Market Returns
- Share Class Litigation
- Emerging CIT & ETF Solutions

Fiduciary Oversight
- 408(b)(2) Fiduciary Status
- 3(21) & 3(38) Services
- Regulatory Enforcement

Key Drivers

Outcome

- Fee Compression
- Fee & Service Justification
- Open Architecture Platforms
- Benchmarking

- Fund Bias Exposure
- Participant Advice
- Unrestricted Fund Choice
- Low Cost Alternative Options

- RIA Involvement
- MEP Solutions
- Expanding Role of the Expert

Fund Choice Outcome

Key Drivers Outcome

Current Trends Outcome
Investment Challenges of TDFs
Retirement Roulette

401(k)s: The Baby of the Bull Market
Investment Challenges of TDFs

• Loss Potential > Loss Capacity

• Conflicting Definitions of Success

• TDFs Are Not Created Equal

• Glide Paths

• Due Diligence
What’s Normal about Glide Paths?

MarketGlide: Average Glide Path

Source: PIMCO

- 38% Equity
- 44% Fixed Inc.
- 13% Cash
- 5% TIPS/RE/Comm.

Allocation (%)

Years to retirement

Cash
FI – Core
FI – Global
FI – High Yield
FI – EM Bond
TIPS
Long TIPS
Real Estate
Commodities
Equities – US Large Cap
Equities – US Small Cap
Equities – Global
Equities – EM

Source: PIMCO
Investment Due Diligence Process

• Documented Due Diligence of:
  – Asset classes and sub-asset classes
    • Underlying holdings (and attribution)
  – Withdrawal and/or reinvestment assumptions of TDF
  – Glide Path
    • Investment rationale for Glide Path
    • Analysis of Glide Path stability
    • Degree of tactical asset allocation

Investment Due Diligence Process

- Documented Due Diligence of:
  - Stress Testing
  - If proprietary, evaluation of underlying funds/mgrs.
  - Understanding what drives returns
  - Manager Compensation

Rewarding Performance

<table>
<thead>
<tr>
<th>Short-Term</th>
<th>Long-Term</th>
<th>Gathering Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>7</td>
<td>3</td>
</tr>
</tbody>
</table>

Risk Factor Analysis

Breakdown of total volatility by key risk factor (%)

- U.S. equities
- Global equities
- EM equities
- U.S. bonds
- Global bonds
- High yield bonds
- EM local bonds
- Real estate
- Commodities

Source: PIMCO
Conviction in Their Own Ideas?

• Do Fund Managers Actually Invest in Their Own Funds?

  — Per the Morningstar study...

  • “In two separate 2011 studies, Morningstar found a correlation between managers who invested substantial sums in their funds and superior relative fund performance.”

  • “Of the 38 series...managers of 18 have zero dollars invested... Most fund managers don’t invest a dime in the mutual funds they run. But given the importance and growing prominence of target-date funds...this low co-investment is disappointing.”

  • “Across the industry, just one manager...meets the highest industry standard...owning shares worth more than $1 million. One other manager... owns shares in two of [his] funds, with one investment valued between $500,000 and $1 million while the other is worth between $10,000 and $50,000.”

Fiduciary Challenges of TDFs
Plan Sponsor Awareness

• Prudence Still Reigns
  
  “[N]othing in [the regulation relieving fiduciaries of liability for losses resulting from a participant’s investment in a QDIA] shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any qualified default investment alternative…”

• Fiduciary Disconnect

• Balancing QDIAs with Participant Education/Communication

Fiduciary Challenges

• **Alignment with Plan Goals**
  – Risk tolerance of participants
  – Retirement readiness and needs of participants

• **Decision Making**
  – How do I choose?
  – How do I monitor? What things do I even look for?

• **Additional attention for QDIAs**

• **Direct competition with fund lineup**
What Are You Paying For?

• Active vs. Passive
  – Active Share
  – Is it a ‘closet indexer’?

<table>
<thead>
<tr>
<th>Active Share</th>
<th>100-85%</th>
<th>84-70%</th>
<th>69-55%</th>
<th>54-0%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>26</td>
<td>5</td>
<td>6</td>
<td>8</td>
</tr>
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</table>

• Open vs. Closed
  – Proprietary (closed) platforms
  – Mixed platforms
  – Open-architecture platforms

<table>
<thead>
<tr>
<th></th>
<th>Closed</th>
<th>Mixed</th>
<th>Open</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>24</td>
<td>10</td>
<td>7</td>
</tr>
</tbody>
</table>

How Much Are You Paying?

- What’s normal? What’s high? What’s low?

### Net Expense Ratio

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<tr>
<th></th>
<th>Average</th>
<th>High</th>
<th>Low</th>
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<tbody>
<tr>
<td></td>
<td>0.83%</td>
<td>1.31%</td>
<td>0.18%</td>
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</table>

### Asset Class Comparisons

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Average</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Cap Core</td>
<td>1.26%</td>
<td>2.05%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Intermediate Bond</td>
<td>0.90%</td>
<td>1.72%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Balanced Allocation</td>
<td>1.38%</td>
<td>2.15%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>

Source²: fi360
DOL: TDF Tips for ERISA Fiduciaries

- Establish a process for comparing and selecting investments.
- Establish a process for the periodic review of selected TDFs.
- Understand the fund’s investments – the allocation in different asset classes, individual investments, and how these will change over time.
- Review the fund’s fees and investment expenses.
- Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan.
- Develop effective employee communications.
- Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection.
- Document the process.

Source: DOL
Trickle-Down Effect

• Shift of Burden

• Depends on your fiduciary status
  – Non-fiduciary
  – 3(21)
  – 3(38)

• Opportunity or Threat
Where Do We Go From Here
Rethinking QDIAs

• Redefining “Success”

• Drivers of QDIAs

• Solution rather than Product

• Manage Risk Exposure

• Prudent, Conflict-Free, Transparent
Best Practices for Sponsors & Advisors

- Back to Basics (mostly)
- QDIAs Are Different
- Justification of Fees
- Process over Outcomes

<table>
<thead>
<tr>
<th></th>
<th>Good Outcome</th>
<th>Bad Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good Process</td>
<td>Deserved Success</td>
<td>Bad Break</td>
</tr>
<tr>
<td>Bad Process</td>
<td>Dumb Luck</td>
<td>Poetic Justice</td>
</tr>
</tbody>
</table>

Sources: Russo & Shoemaker, *Winning Decisions*.
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