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Insights

White label fund options for DC plans

By the Willis Towers Watson Defined Contribution Steering Committee

The Defined Contribution Steering Committee (DCSC) assesses trends in the defined contribution (DC) landscape and develops intellectual capital on our clients' behalf and helps meet the evolving needs of participants.

Introduction

Two of the primary factors that may lead to successful retirement outcomes within DC plans are participant savings and the return on investments. Plan design features such as auto-enrollment and auto-escalation are making a significant impact on saving behavior, just as we have seen target-date funds revolutionize the asset allocation option in most plans. Meanwhile, the core lineup of the vast majority of plans has remained largely unchanged over the past 20 years. We believe it's time for DC plan sponsors to rethink these legacy investment lineups. In this paper, we focus on reframing the design of actively managed options with an emphasis on fewer, broader investment options to ease participant decision making.

Evolution needed in DC lineups

Historically, DC plan structures have been anchored to lineups that are constructed with a number of single, stand-alone active funds with style and capitalization biases. We have long been advocates for simplifying lineups for participants while also maximizing the ability to diversify underlying structures. We believe investment labels oversimplify manager approaches with simple style and capitalization descriptions, resulting in poor diversification.

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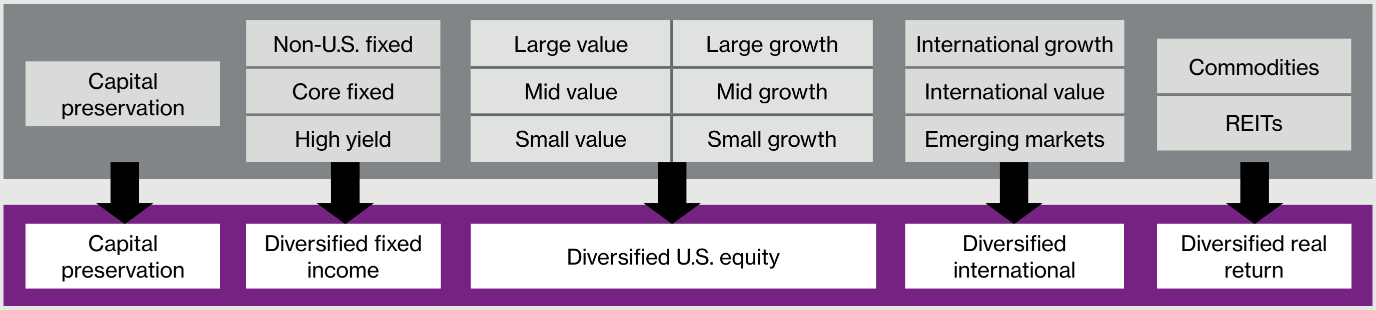
We recommend plan sponsors consider their governance, beliefs and demographics when determining the building blocks that may be utilized for a baseline structure. A lower governance approach may include, for example, low-cost passive target-date funds and a limited number of passively managed index funds for participants who wish to make personalized asset allocation decisions. Sponsors can then consider their beliefs, scale and available resources to determine the suitability of additional options or active management. Questions to ask should include: "Do we possess the resources and expertise to effectively evaluate active managers?" and "Are our participants capable of making informed portfolio construction decisions related to active management?" Where active management is employed, it may warrant moving away from the traditional style-box approach toward broader investment strategies with less geographic, capitalization or stylistic limitations to simplify participant choice and encourage better decision making. *Figure 1* shows one way a plan sponsor may choose to simplify its actively managed portfolios.

Figure 1. *For illustrative purposes only*

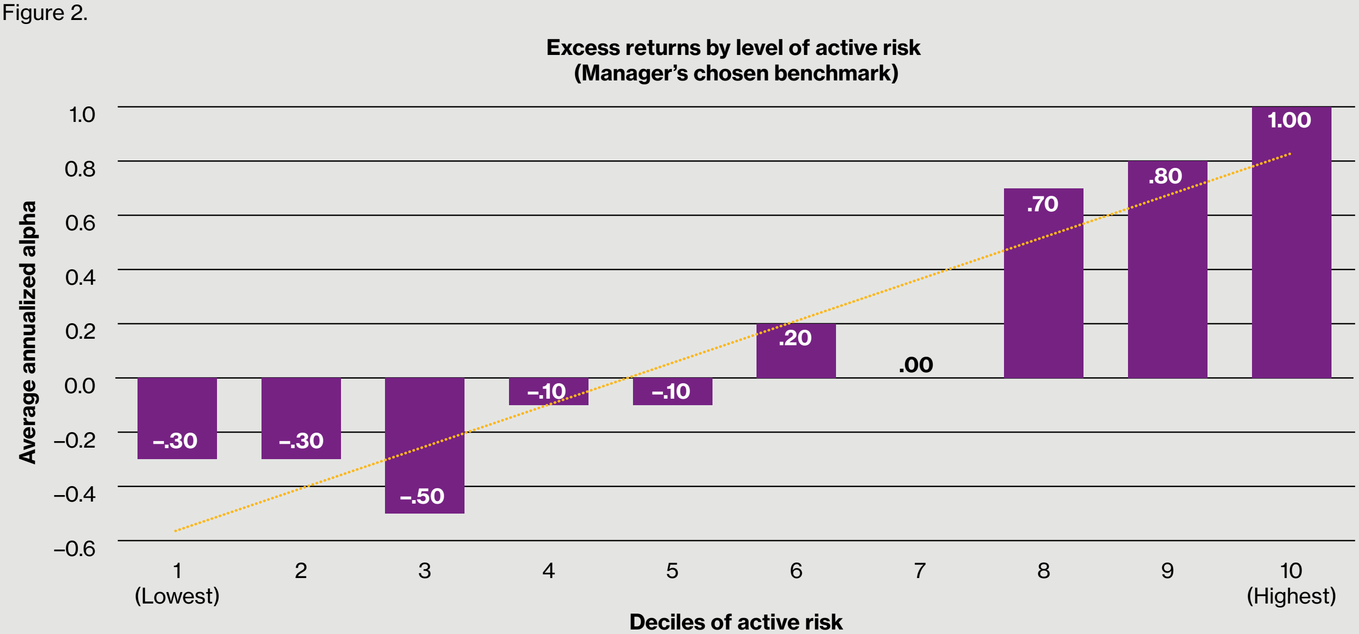


The case for white label options – participant benefits

Indeed, when implementing active options in a DC lineup, multimanager portfolios may represent an efficient way to try to capture the full-market opportunity set and look to combine complementary investment strategies for streamlined participant decision making. We believe investment options should be simple on the surface for the sake of participants while integrating sophisticated investment concepts such as portfolio construction, diversification, risk management and fee budgeting. Creating these customized options may require significant governance resources and is more complex operationally than utilizing stand-alone managers. While plan sponsors with sufficient time, expertise and resources to properly oversee these options should consider them, we have found lower governance models may be well served by stand-alone options, although with some additional considerations as described below. Notably, sponsors without the appropriate resources in-house may elect to utilize a delegated solution provider to leverage their expertise and capabilities in order to create custom options for their plan.

We believe accessing better investment opportunities is instrumental in influencing future returns. Based on our experience, many stand-alone, active equity funds seen in DC investment lineups today are overly diversified and don't justify their relatively high investment management fees. This may be largely due to a mismatch between participant active risk tolerance (typically very low) and the active risk profile (typically very high) necessary to generate sufficient long-term outperformance to warrant the higher cost of active management. As evidenced by *Figure 2,* active managers that are willing to stray farther from the benchmark have a greater likelihood of adding value over time.

Figure 2.



One problem we find with high active share managers is that the disparity with the benchmark can also increase tracking error relative to the benchmark. At higher levels of active risk, a manager is likely to experience periods, sometimes long periods, of underperformance before adding value. This creates a unique challenge for plan sponsors to bridge the gap between higher active risk options that have a greater opportunity to add relative value and lower active risk options that are more tolerable to plan participants. Multimanager white label fund options can be a potential solution for many plans. These custom options can blend multiple high active risk managers with complementary styles alongside lower-cost passive and smart beta strategies. The resulting investment options seek to offer participants broad asset class exposure to skilled managers potentially at a total net cost below that of many overly diversified stand-alone active fund options. Through smarter portfolio construction, the resulting structure may be expected to offer similar return at lower risk or higher return at similar risk.

The case for white label options — sponsor benefits

Another potential benefit of white label fund options is the increased control afforded to the plan sponsor to make changes to the underlying fund managers. With a single manager stand-alone option, most plan sponsors will rely upon safe harbor provisions in making fund changes, which require at least 30 days' notice to all plan participants before replacing a fund. In periods of stress, this can present challenges for plan sponsors that may wish to make a change to the investment lineup sooner. As an example, consider a scenario in which the lead portfolio manager of an investment fund suddenly and unexpectedly departs his or her organization, leaving significant uncertainty about the future of the fund. In this instance, a sponsor may be concerned about a resulting mass exodus of assets from that fund and wish to replace the fund as quickly as possible. As a stand-alone option, the sponsor would be forced to weigh the fiduciary risks of forgoing safe harbor protections in making a lineup change versus the risk that the existing fund management organization might deteriorate in the very near term and create investment losses. Furthermore, even if the sponsor opts to forgo the safe harbor communication, the plan recordkeeper may not be in a position to facilitate a change on such short notice. In this instance, we have found that in a white label fund structure the decision is much easier. The plan sponsor has flexibility to replace the existing fund with a replacement option on short notice or reallocate among the other underlying funds. Common approaches are to reallocate assets to the passive fund option(s) within the white label structure or to a transition manager while taking the time to identify a long-term replacement. The 30-day fund change communication is typically not required in this situation because the white label structure remains intact.

The largest plan sponsors may find white label funds very attractive for their ability to leverage the scale of the plan to access cost-effective investment vehicles with the potential to reduce total plan costs. We continue to see a migration within stand-alone fund options from traditional 40 Act mutual funds toward more institutional collective investment trusts (CITs). However, large plans may be able to go a step further and utilize separate account structures that may offer even lower fees. A plan sponsor already utilizing separate accounts for underlying investment strategies has less of an additional operational burden when setting up a white label structure. Requirements for setting up a white label structure include the determination of a daily net asset value for each fund and the creation of custom fund fact sheets, typically produced on a quarterly basis. The cost of these services can be rolled into the total expense of each fund, which, with the appropriate scale, are still often lower than comparable mutual fund or CIT vehicles.

Constructing a white label fund

To help effectively construct multimanager white label options, we have developed a framework grounded in several key principles:

- Combine effective risk management and high-quality implementation to improve investment efficiency
- Focus on multiple measures of risk, such as volatility, drawdowns and liquidity risk, to assess trade-offs
- Determine desired economic exposures, taking care to achieve portfolio characteristics that contribute to diversification and are not redundant
- Focus on investment ideas where you can capture returns from competitive advantage
- Only use active management where the net of fee proposition is compelling (expenses and active share are key factors)
- Control cost via selectivity, robust fee negotiation with investment managers, and employing smart beta strategies such as risk and exposure management tools

- Aim to manage any unwanted biases within the structure, and scale any intended biases to the desired level (this fit of different managers is crucial and should be tackled from both a qualitative and quantitative standpoint)
- Look to adapt with market conditions to capture new opportunities by preserving flexibility in the structure (as opportunities evolve, be confident that the portfolio can respond)

The resources and experience necessary to implement these principles means that many plan sponsors will not be in a position to create and oversee white label options without help. Plan sponsors should work with their advisors to determine the appropriateness of white label options within their lineup and to determine what, if any, outside resources to leverage.

Conclusion

The role of the DC plan has changed significantly in recent years from a supplemental savings vehicle to the primary retirement plan for many participants. As such, the structure of DC lineups should similarly evolve. This means focusing less on investment choice for the most engaged participants and more on investment simplicity to benefit the average participant that will rely on the plan to ensure their ability to retire effectively. With this increased focus on simplicity, plan sponsors should try to take advantage of leading portfolio construction methodologies to create a few broad, multimanager investment options that may improve outcomes for DC participants.

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