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Defined Contribution:
The White Label Free Lunch

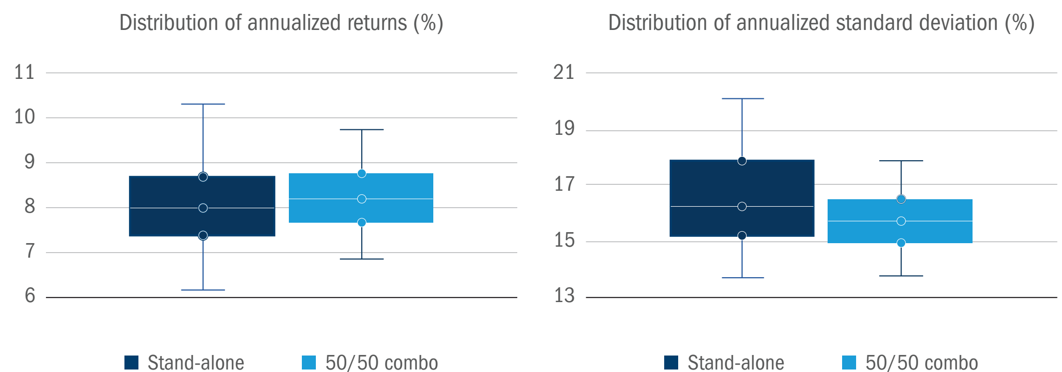
Jeff Gabrione
Head of U.S. Manager Research, Buck Global, LLC

Jason Shapiro, CFA, FRM, CAIA
Director, Columbia Threadneedle Investments

It's fair to say that 2022 was an eventful year for defined contribution (DC). On the regulatory side, the Department of Labor published their final rule intended to remove barriers to considering ESG in retirement plans in November, and shortly after, Congress passed SECURE 2.0. With these meaningful trends at the forefront, one perennial "hot topic" that seems to have taken a back seat is white label funds.[1] This is surprising given that nearly $1 trillion in white label assets are managed by institutional consultants.[2]

With that in mind, we sought to take a fresh look at custom white label funds to reassess their potential value. In particular, we examined multi-manager strategies versus implementing stand-alone options across U.S. Large Cap Equity, U.S. Small Cap Equity, Non-U.S. Equity, and Core Plus Fixed Income with consistent, attractive results. We review the output of the U.S. Large Cap analysis here as an illustration. In Exhibit 1 below, we compare the long-term performance of U.S. Large Cap Growth and U.S. Large Cap Value managers ("stand-alone") with the performance of hypothetical white label strategies consisting of 50% U.S. Large Cap Growth and 50% U.S. Large Cap Value. The distribution of returns are improved on the downside for the 50/50 combinations with 5th percentile annualized returns of 6.9% vs. 6.2% for stand-alone strategies. The median return is 0.2% higher for the combinations, and you would need to look out to the 95th percentile to see the stand-alone options provide higher returns (10.3% versus 9.7%). The distribution of risk, defined as standard deviation of returns, is equal at the 5th percentile but lower at all other points examined for the combinations. At the median, the stand-alone distribution had a standard deviation of 16.2% versus 15.7% for the combinations.

Exhibit 1: Risk and return distributions for stand-alone versus 50/50 multi manager white label strategy

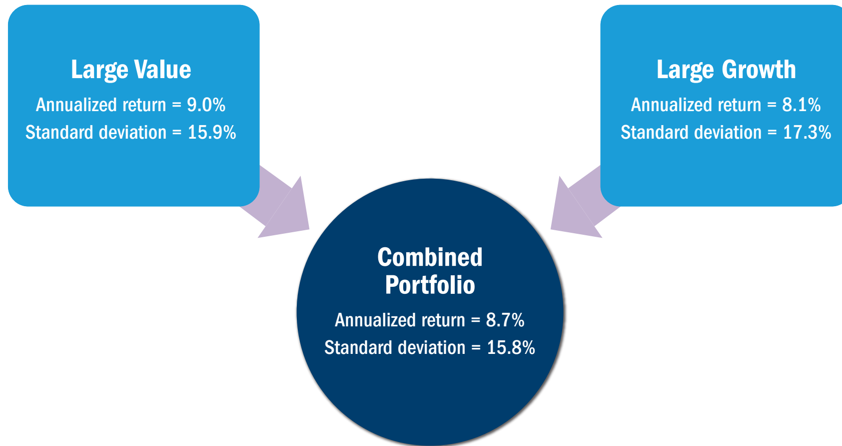


Source: Columbia Threadneedle Investments, based on data from eVestment. Returns and standard deviation are shown for the 25-year period ending December 31, 2022, and are based on net of fee total returns for managers with at least a 25-year history in the eVestment U.S. Large Cap Growth (81 constituents) and U.S. Large Cap Value Equity (95 constituents) universes. The standalone data utilizes all of the managers in the U.S Large Cap Growth and U.S. Large Cap Equity universes at the individual strategy level. The 50/50 portfolio combinations are composed of all of the combinations of a large value and large growth strategy from the eVestment universes, including all strategies with at least 25-year histories and rebalanced monthly. Distributions above are 95th percentile at the top, 75th to 25th in the box the middle line representing the median, and 5th at the bottom. We reviewed each strategy as a standalone as well as a 50/50 combination of each value and growth strategy (>7,600 combinations). While this is certainly a simplified approach, it allows us to take a broad, systematic look at potential benefits of white label funds.

These results suggest that even the naive diversification achieved through the 50/50 combinations dominates the stand-alone options from a distribution of outcomes perspective.[3] Plan sponsors building white label options typically use more sophisticated approaches, combining multiple high conviction strategies with deliberate weightings to pursue desired risk levels, portfolio exposures and expected returns.

Reviewing the outcomes for the full universe is informative, though may be a bit opaque, so we also show a 50/50 combination of a single U.S. Large Value strategy and U.S. Large Growth strategy to add tangibility.[4]

Exhibit 2: Illustrative results from multi-manager combination

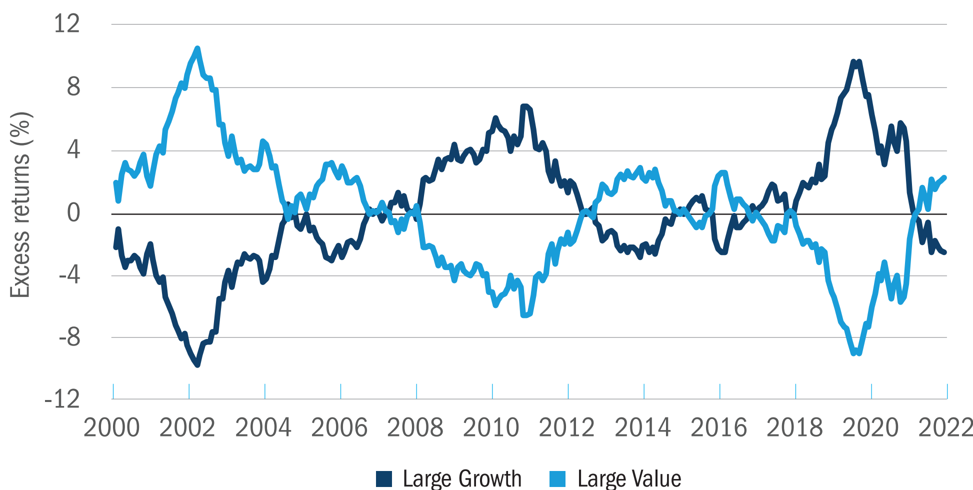


Source: Columbia Threadneedle Investments, based on data from eVestment. The managers used for this illustrative example were the median risk (standard deviation) managers from the U.S. Large Value and U.S. Large Growth universes respectively. Returns and standard deviation are shown for the 25-year period ending December 31, 2022, and are based on net of fee total return. The combined portfolio represents a 50% allocation to each strategy, rebalanced monthly.

When compared to the large growth strategy in isolation, the combination provided a higher return at a lower risk level. When compared to the large value strategy, the combination was slightly lower risk and return.

The path of returns is just as important as the long-term results. The chart below reviews the 3-year rolling excess returns of the stand-alone strategies relative to the combination.

Exhibit 3: Rolling 3-year excess returns of single strategies relative to 50/50 combination



Source: Columbia Threadneedle Investments. Large-cap growth and large-cap value are represented by median managers based on risk (using standard deviation) for the eVestment U.S. Large Cap Growth universe and U.S Large Cap Value universes. Rolling excess returns are based on net of fee total return vs. the manager's benchmark.

As shown, there are periods where both stand-alone strategies materially outperform and materially underperform the combination. This highlights that even if individual strategies achieve their goals of outperforming their benchmarks, participant outcomes may be challenged if they are overexposed to a style that is out of favor, such as the dot-com bubble in the early 2000s or the growth rally that reversed in late 2021–2022.

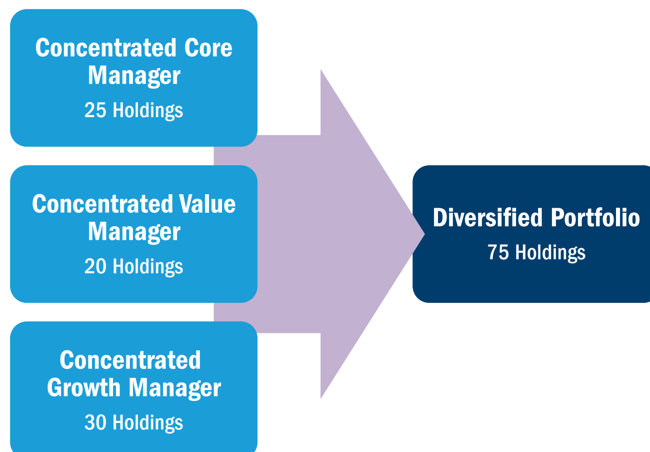
As shown above, multi-manager white label funds may provide benefits to participants. They also provide flexibility to plan sponsors who can implement structures and solutions that may otherwise be difficult. These include:

Utilizing managers that may not be suitable as stand-alone DC options

It is common for skilled managers to concentrate their portfolios toward their best ideas. This is ideal for differentiating from the market though often comes with higher risk levels. High tracking error or meaningful factor tilts, may not be a problem for institutional asset owners who can manage risks at the total asset pool level. In defined contribution plans, however, individual participants make personalized allocation and timing decisions, leading to the potential to buy high, sell low or both. Research has shown that participant timing decisions have detracted significantly from returns, costing nearly 200 bps per annum over a long-term time horizon according to a study by Hsu, Myers and Whitby[5] and about 170 bps per annum according to Morningstar.[6] In fact, when compared to a buy and hold return for the S&P 500 and Bloomberg U.S. Aggregate over the past 30 years, investors trailed by 2.8% per year and 4.7% per year, respectively.[7]

As the illustration below shows, combining concentrated strategies mitigates these risks by simplifying participant decision points and creating well-diversified portfolios.

Exhibit 4:



Source: Columbia Threadneedle Investments. For illustrative purposes only.

Leveraging broader asset management relationships for scale benefits

Consider the example of a plan sponsor with both a defined contribution and a defined benefit (DB) plan. The sponsor may allocate to managers that are already in the DB plan within a white label structure as well. This not only provides scale benefits, such as lower fees, but also streamlines governance via efficient oversight. White label funds may also support the use of institutional vehicles such as separately managed accounts, as the custom white label funds are unitized to be single investment options with single net asset values. Said differently, many of the operational and administrative tasks needed to implement a separate account are already taking place with the creation of a white label fund.

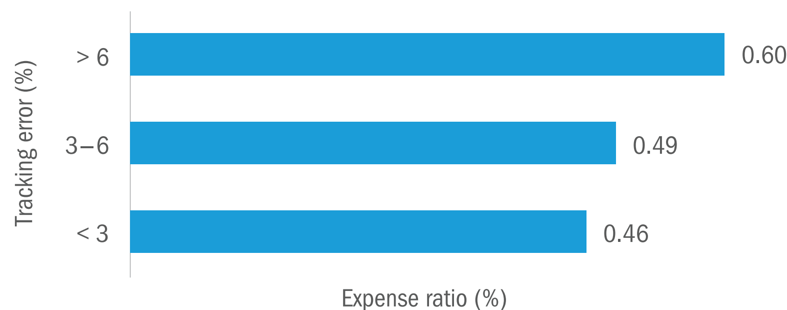
More seamless manager transitions

If a manager change is required in a multi-manager white label fund, whether for strategic repositioning or due to challenges at an incumbent manager, the participant experience is undisturbed. The white label fund, as a structure, remains intact, so from the participant's perspective it's almost as if nothing has changed at all. To this point, while many sponsors choose to communicate underlying manager changes to participants, the 30-day required fund change communication is typically not required. Another potential benefit of transitions occurring "underneath the hood" of the white label fund is that participants are not influenced by the brand names of certain asset management firms.

Engaging in fee and risk budgeting as part of portfolio construction

If a plan sponsor considers utilizing stand-alone strategies, they should keep in mind the relationship between active risk and cost. If we use tracking error[8] as our active risk metric and review the large cap U.S. equity universe as an example, we see an increasing relationship between tracking error and fees.[9]

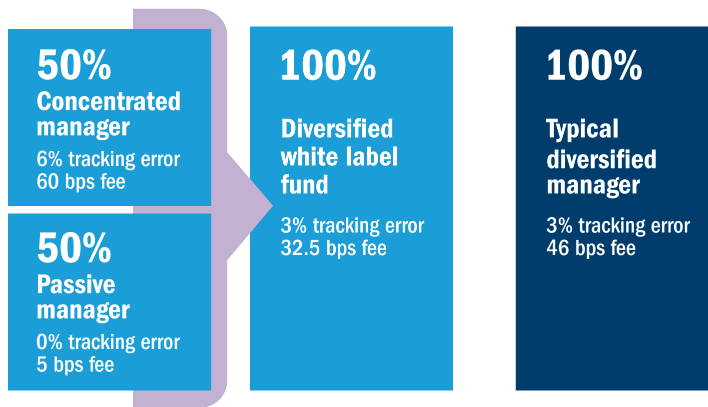
Exhibit 5: Higher tracking error generally means higher expense ratios (average fee by tracking error buckets)



Source: Columbia Threadneedle Investments, based on eVestment Alliance All Large Cap U.S. Equity universe as of December 31, 2022. Tracking error is the 5-year trailing tracking error using the manager-preferred benchmark. Fees are for separate accounts assuming a $100 million mandate.

This suggests that if a sponsor targeted a tracking error of 3%, they could expect a fee of around 46 basis points. This is less expensive than higher tracking error strategies though the sponsor is still paying active management fees for a portfolio which may have a lower active share.[10] Alternately, the sponsor could combine a high conviction, high tracking error manager with a passive strategy to achieve the same risk level at a potentially lower fee as shown in the below illustrative example.[11]

Exhibit 6: A 50/50 multi manager white label strategy may offer lower fees than a typical diversified manager



Diversified white label fund has the same active risk but at a fee that is 13.5 bps lower.

Source: Columbia Threadneedle Investments, based on eVestment Alliance All Large Cap U.S. Equity universe as of December 31, 2022. Tracking error is the 5-year trailing tracking error using the manager-preferred benchmark. Fees reflect management fees for separate accounts assuming a $100 million mandate. Additional fees may apply.

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This approach can also be used to balance out factor exposures. For example, if a sponsor believes that a highly cyclical growth manager has a lot of skill but is concerned about exposing participants to the risks of a style tilt, a white label fund with an allocation to the manager along with active or passive value strategies can provide a style-neutral portfolio that allows for tailored active risk and fees.

Ability to access extended asset classes directly

For broader mandates such as global equity, multi-sector fixed income or multi-asset, sponsors are often limited to choosing strategies where one manager handles all the underlying components. Conversely, white label funds allow for allocations to multiple managers to find best-in-class strategies in each segment. Some examples of this include:

- Global equity funds with separate managers for U.S. equity, non-U.S. developed equity and emerging markets equity
- Multi-sector fixed income funds with separate managers for corporate credit, structured credit, high yield, loans, etc.
- Multi-asset funds with various managers across equities, fixed income and alternatives

As alluded to above, white label funds not only provide the ability to tailor exposures but also offer the opportunity to access asset classes not typically found in defined contribution plans historically, such as private real estate, alternative credit and private equity.

Of course, white label funds also have considerations that plan sponsors should weigh when evaluating them. Operational and administrative needs are more complex – sponsors should ensure that their recordkeepers and custodians can implement custom fund structures, including factors such as striking a net asset value and creating custom communications. These factors, plus other trust and custody services, add additional fixed costs that require scale so that they become de minimis as a portion of total cost. This typically requires total plan sizes of near $1 billion and above to be economically feasible. Additionally, the sponsor will have to set the fund's asset allocation, establish a rebalancing policy, manage cash flows and carry out other ongoing monitoring and management tasks. Our view is that the benefits often outweigh the costs, though sponsors should certainly have a full understanding of the relevant factors before undertaking a review of custom fund structures.

After reviewing the potential benefits, considerations and uses of white label funds, perhaps it is a topic that should remain in the limelight. We view white label funds as a flexible solution that can potentially improve participant outcomes in several ways – including potentially facilitating smoother implementation of the headline trends in the industry today such as retirement income and ESG. As defined contribution plans are increasingly asked to serve as a primary retirement source for workers, the flexibility of white label funds provides a powerful tool to improve retirement readiness.

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[1] White label funds are bespoke investment structures with one or more strategies inside them. They are designed and maintained by plan sponsors for the benefit of their plan participants and beneficiaries.
[2] PIMCO U.S. Defined Contribution Consulting Study, 2022. pimco.com/dc-survey
[3] Diversification achieved through less than perfectly correlated return streams and also through systematic rebalancing, which adds value when strategies mean-revert over time
[4] Reflects the median risk large value manager combined with the median-risk large growth manager in the eVestment universes, based on standard deviation
[5] Hsu, Jason C., Myers, Brett W. and Whitby, Ryan, Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies (May 1, 2015). Journal of Portfolio Management, Vol. 42, No. 2, 2016
[6] Morningstar – Mind the Gap 2022
[7] Quantitative Analysis of Investor Behavior, 2023, DALBAR, Inc. www.dalbar.com Data as of December 31, 2022 updated annually
[8] Volatility as measured by the standard deviation of the difference between the returns of an investment and its benchmark
[9] Source: eVestment Alliance, All Large Cap U.S. Equity universe as of December 31, 2022. Tracking error is the 5-year trailing tracking error using the manager-preferred benchmark. Fees are for separate accounts assuming a $100 million mandate. Increasing relationship held in other asset classes examined.
[10] Morningstar – Mind the Gap 2022 Active share measures of the percentage of portfolio holdings that differ from the benchmark
[11] For simplicity we assume a tracking error of zero for the passive strategy

Past performance does not guarantee future results. It is not possible to invest directly in an index.

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