COLUMBIA THREADNEEDLE
INVESTMENTS

Defined contribution

It's time to give the core lineup some respect!

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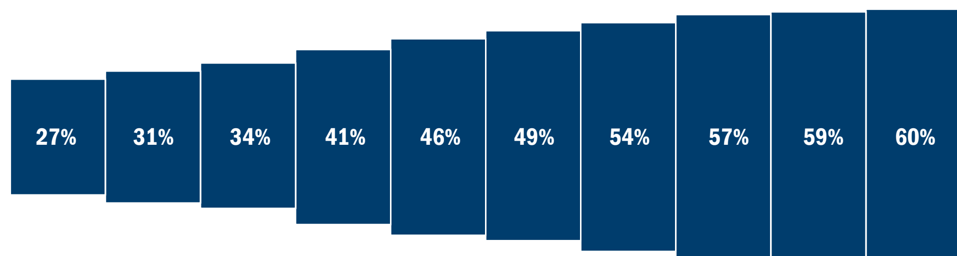
The defined contribution (DC) market in the United States is massive. Pension assets in the U.S. have grown from $10.1 trillion in 2000 to an estimated $36.6 trillion in 2020.[1] DC assets are approximately 64%[2] of that total — over $23 trillion. This tremendous growth has positioned DC as the primary retirement vehicle for many U.S. workers through innovations designed to help participants enroll and save in these plans. For example, auto-enrollment and auto-escalation features have been extremely effective at increasing plan participation. According to Vanguard's recordkeeping data, 54% of plans offered auto-enrollment in 2020, up from 2% in 2004.[3] Of those plans offering auto-enrollment, 69% also increase contributions automatically. The participation rate for auto-enrolled participants is estimated at 92%.[4] Additionally, proposed regulations aim to improve retirement security through required auto-enrollment and escalation in new plans. Of course, this trend has implications for investment allocations. In 2020, 60% of contributions went into target-date funds (the typical default option), up from 27% in 2011.[5]

Exhibit 1: Plan contribution allocation to target-date funds



Source: Vanguard 2021

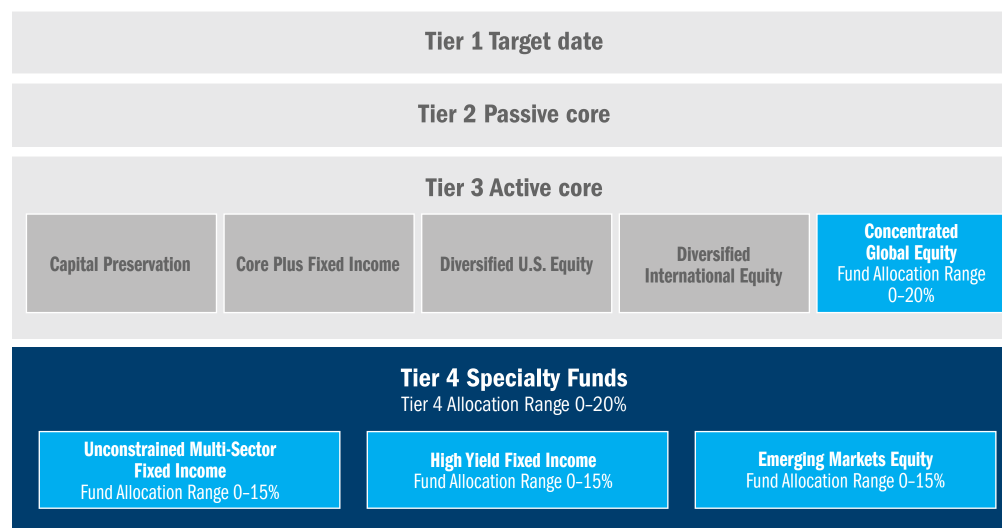
The average participant-weighted allocation to target-date funds in 2020 was 66%,[6] a huge increase over time that has been "funded" by relative decreases in other parts of the DC structure, mainly the core lineup.[7] These trends have helped participants that may not have otherwise saved to contribute to their plans. The status-quo bias for defaulters, however, has also taken attention away from the core lineup. In our opinion, this has led to the core lineup evolving less over time than it potentially could have. It's time to give the core lineup some respect!

Before we go too far, we should first ask, is this disproportionate weighting even a problem? Perhaps it is, considering that as of September 30, 2021, 58.1% of target-date fund assets were passively managed.[8] Still, plan fiduciaries and their consultants are spending considerable time and effort selecting core options intended to be best-in-class. For example, when looking at global equity managers over the past 10 years (ending September 30, 2021) the median manager added 0.1% in excess return per year while a 25th percentile manager added an annualized 2.2% over the benchmark. Within U.S. core plus fixed income, the median manager added 1.1% in excess return per year and the 25th percentile manager added an annualized 1.4% over the benchmark.[9] Clearly, active management can provide significant benefits to participants.

Results relative to passive approaches may also be improved through greater diversification. Esoteric asset classes often make their way into DC plans through custom implementations, including white label core funds and custom target-date funds.[10] Given that many sponsors cannot implement custom funds, how can the core lineup evolve to provide exposures in plans unable to pursue bespoke options?

One way this may be accomplished is through the explicit use of portfolio constraints. One potential example of this is shown in exhibit 2 below:

Exhibit 2



Illustrative. Plan lineups will differ, and this is meant to serve as one, non-prescriptive example.

There are a few points worth highlighting in this example:

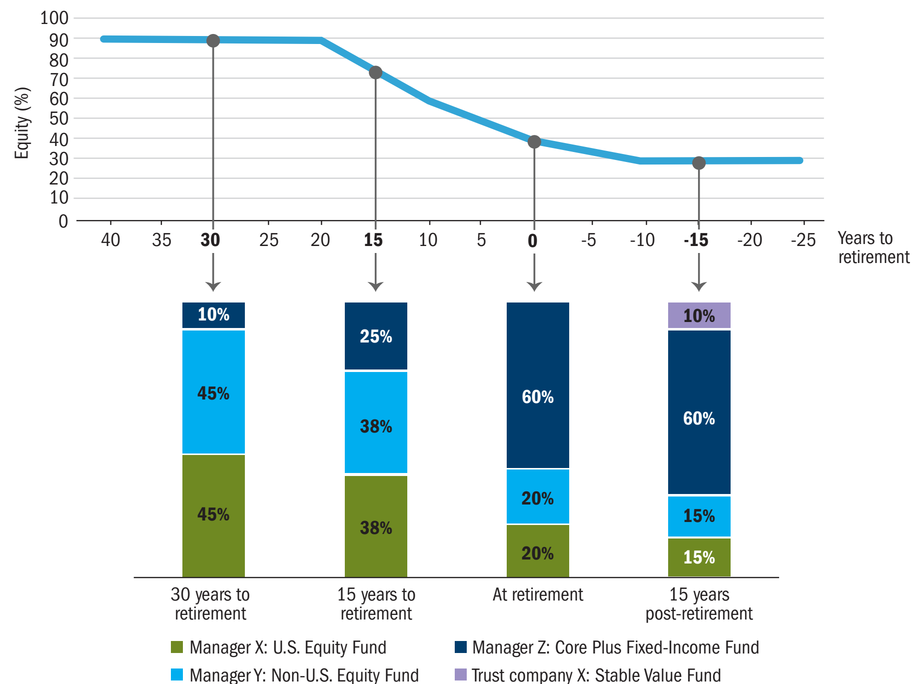
- The concept of portfolio optimization with constraints is nothing new. Market practitioners often place reasonability constraints around certain categories for pragmatism. This is similar to part of the process a manager might use when creating a target-date series.
- In the example above, participants could access specialty asset classes with allocation caps, and an additional constraint is added to the total specialty funds tier to manage the overall exposure to these strategies.
- Streamlining has been a prevalent trend in DC lineups for years, driven by participant behavioral considerations. We believe these are valid considerations but also feel that there is an opportunity to leverage improving technology, advice and communications to offset concerns about adding a few additional options. From a portfolio construction perspective, the benefits may outweigh the costs.

For those that feel this idea is appealing but are not fully comfortable with implementing constraints, there may be ways to relax restrictions while still protecting the broader participant base — for example, requiring formal documentation and acknowledgment of risks before having full access (like when opening a brokerage account) or by requiring a financial literacy assessment. Of course, these ideas would require discussion with ERISA counsel.

We understand that this concept goes against the grain in an industry that has been so successful in simplifying exposures and lowering fees, largely through increased exposure to passively managed options. DC sponsors and consultants should be proud of what has been accomplished. Still, with simpler allocations and fees at all-time lows, we need to ask ourselves some challenging questions. Perhaps most relevant is, have we created a system where most participants will successfully achieve retirement readiness? The first quarter of 2020 serves as a good reminder that there are still significant risks to manage. The median "2020" target-date fund returned -10.7% in a quarter where the S&P 500 returned -19.6% — hardly the downside protection those entering retirement would hope for. In fact, when looking at the top three target-date managers who represent ~62% of total target date assets,[11] the return over the period was -12.4%, about 63% of the drawdown of a pure U.S. equity exposure. Additionally, the proliferation of new ideas in areas such as pooled employer plans, lifetime income and custom funds with higher conviction exposures suggests that there is more to do. As such, we offer one additional forward- thinking idea that may improve expected outcomes for participants.

We noted the considerable size of the U.S. DC market earlier, which supports a target-date industry equally impressive in scope. The lion's share of the target-date market is invested in either passive funds or proprietary active funds. A sponsor may consider working with their recordkeeper to use a model portfolio system that maps participants to the plan's target-date glidepath using the core options. An example of this is shown in exhibit 3 below:

Exhibit 3: Target-date glidepath



Illustrative. Plan lineups will differ and this is meant to serve as one, non-prescriptive example.

This would allow a participant to receive the same asset allocation benefits as a target-date fund while leveraging the high conviction actively managed options that the plan fiduciaries selected and monitor on an ongoing basis. Like the prior example, this idea also has benefits and considerations.

Benefits	Considerations
Access to high-quality active management	Plan sponsor and/or consultant need to take responsibility for fund mapping
Potential additional downside protection relative to passive and/or proprietary implementations	Requires coordination with and operational support from recordkeeper
Fee benefits from scale in core lineup	Requires communications, education and reporting
Mapping can be in one-year increments instead of the typical five, leading to less allocation mismatch	Participants would need to opt-in, potentially leading to lower take-up rates
Rebalancing provided by recordkeeper	Recordkeeper may charge additional fees for service

These ideas are not meant to be overly prescriptive; rather, they aim to start a discussion about ways to improve the potential outcomes for participants who want to use the core lineup. There are also other reasons that sponsors may want to pay additional attention to the core lineup and give it some RESPECT:

Retirement income	It will take some time before default solutions with embedded lifetime income are commonplace. In the interim, the core line-up can be an effective way to transition from the current state to one where lifetime income is more prevalent.
ESG	Remains top of mind for plan sponsors and may potentially be best expressed through the core line-up. Recent Department of Labor language seems to remove some ESG barriers but mass adoption within default options seems unlikely in the near-term.
Scale benefits	Better alignment between the building blocks used in the default option and the core line-up allows for greater purchasing power which can lower fees for all participants.
Personalization	Improvements in technology, guidance tools, robo-advice, and financial wellness offerings provide greater opportunities for participants to use the core line-up as part of an ongoing, holistic retirement plan.
Evolution of QDIAs	Increased adoption of managed account services, custom target date funds, and hybrid solutions provide ways for participants to access the core line-up with a professional advisor building and monitoring the exposures for them.
Co-fiduciary models	The continued trend toward outsourcing allows plan sponsors to construct best-in-class core line-ups in a risk-controlled manner with the support of a co-fiduciary.
Target date misuse	Participants may be misusing target date funds. For example, in 2019, 45% of actively-employed investors held partial allocations to target date funds and 10% of people allocated to more than one target date vintage.[12]

So much strategic attention is paid to the plan default (and for good reason) that we may be overlooking opportunities to support millions of DC participants accessing the core lineup to prepare for their retirements. We need to look at the current limitations in DC core lineups as challenges to overcome. Through innovation and collaboration, the future for the DC core lineup, and for the participants using it, is looking pretty bright.

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[1] https://www.thinkingaheadinstitute.org/content/uploads/2021/02/GPAS__2021.pdf, includes IRAs
[2] Ibid
[3] How America Saves 2021 (vanguard.com)
[4] Ibid
[5] Ibid
[6] Ibid
[7] The "core lineup" is the asset class building block funds offered to participants in a DC plan. They include actively managed and/or passively managed options in equity, fixed income, cash, and possibly other categories. The most common options not included in the core lineup would the target date funds, company stock, and brokerage accounts.
[8] Mercer, Target Date Funds – At a Glance, as of Third Quarter 2021
[9] Source: eVestment Alliance. All data is net of fees, n=141 for global equity and 85 for core plus fixed income. Global Equity universe is "Global All Cap Equity" and results were relative to the MSCI ACWI-ND. U.S. Core Plus universe is "U.S. Core Plus Fixed Income" and results were relative to the Bloomberg U.S. Aggregate Index.
[10] These fund structures can access strong active management in traditional asset classes as well as specialty asset classes that aim to increase returns or decrease risk.
[11] Morningstar 2021 Target-Date Strategy Landscape
[12] 2020_Universe_Benchmarks_lite_Report.pdf (alight.com)

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