

## MEMO

TO: State of Connecticut Retirement Security Board Subcommittee  
DATE: July 31, 2015  
FROM: Mercer  
SUBJECT: Investment Options

### **Introduction**

The Connecticut Retirement Security legislation does not explicitly require that the Connecticut Retirement Security Board (CRSB) make recommendations on investment option design; however, the statutes have goals that the investment design will affect. The goals of providing access to a quality retirement program, reducing the need for public assistance, and requiring minimal financial sophistication are directly related to the investment option design. While many of the detailed investment decisions will be left to the governing and managing bodies, the CRSB may want to recommend a particular macro investment design or approach to the Legislature. The CRSB has two potential areas where it might provide guidance to the Legislature: whether the Retirement Security Program (the Program) should offer investment choice and the investment option(s) to be offered.

The memo first outlines the broad investment design choices and aligns these options to meeting participant needs. The memo then provides some contextual information using ERISA plans and their approach to designing investment options. Finally, the memo concludes with an assessment of different potential structures.

### **Program goals & design**

The Legislature has established a fundamental policy goal of achieving sufficient savings for Connecticut workers to retire with security. The investment program is an important element in achieving this objective. At the highest level, the investment program design fundamentally has two design alternatives. The first alternative is to not allow participant choice. All participants would contribute to a pre-selected fund, which could be an asset allocation fund aligned with their age that rolls over time into an income stream or some other construct. The primary point is that the participant has no choice and no decision. The second alternative is to have a default option and a select range of funds from which participants could choose. To determine which approach is preferable, the CRSB must consider participant behaviors and needs.

### ***Participant behavior and needs***

Program participants will have varying levels of financial sophistication, different savings needs and a range of aggregate savings levels. Consequently, a single investment option may be sufficient to cover the majority of participants' needs, but is not likely to be suitable for all investors' needs. Second, regardless of what a participant should be doing, some participants will want flexibility and

choice. In contrast, other participants may be paralyzed in the face of a decision. Consequently, the number of investment options may affect participation rates. Ideally, the market survey will provide insight into this issue and will be useful in ultimately deciding the investment design recommendations. Finally, the number of investment options should be balanced against the potential impact on fees and operating expenses. A lot of options with small balances will be more expensive for each investor.

An approach increasingly adopted by corporate qualified plans is to align the investment design with groupings into which participants self-select. The following broad groupings capture characteristics typically observed across a diverse participant group and can be aligned to the investment options:

<b>“Do it for me” Investor</b>	<b>“Help me do it” Investor</b>	<b>“Leave me to it” Investor</b>
<ul style="list-style-type: none"><li>• Rarely reviews portfolio</li><li>• No engagement in investment allocation decisions</li><li>• Lacking in investment knowledge, interest and/or time to proactively managed investments</li><li>• Wants professional assistance managing investment exposure over time</li></ul>	<ul style="list-style-type: none"><li>• Reviews overall investment allocation occasionally</li><li>• Wants control over major shifts in allocation</li><li>• Limited engagement on implementation, rebalancing and other shorter-term issues</li></ul>	<ul style="list-style-type: none"><li>• Frequently reviews portfolio</li><li>• Utilizes full range of investment options</li><li>• Wants to control all key investment allocation decisions</li></ul>

In constructing an investment design to align with these groupings, the following guiding principles can be used.

**“Do It For Me Investor”:** The design focus is to improve the chance of delivering an adequate and sustainable income in retirement for the participant. Generally, the investment option design includes solutions that consider a participant’s changing needs across their whole life, including what happens at, and after, retirement. “Do It for Me” participants are likely to be the largest segment of the Connecticut Retirement Security Program (the Program) and many of the auto-enrolled individuals have probably not had historical exposure to retirement programs. These participants will likely not have the knowledge, interest, and/or time to make an active investment decision and would prefer to be defaulted into an appropriate investment.

**“Help Me Do It”** and **“Leave It To Me”** participants are more challenging, as they want flexibility, but may make suboptimal choices. The critical questions are: 1. whether these participants will opt out of the program if there is no choice offered and 2. If there is choice, whether the asset balances will be

sufficient in broader funds to make them economically attractive. The CRSB will be in a better position to understand the demand for choice when the market survey is completed.

### **ERISA guidance on investment options**

While ERISA is not likely to be applicable, the CRSB may want to consider ERISA's policy goals and guidance with regard to designing investment options, as this guidance has evolved over many years based on experience and it recognizes that retirement savings plans should serve the broadest number of participants. Section 404(c) of ERISA requires that qualified plans offer a broad range of investment options to provide each participant with a reasonable opportunity to:

1. Materially affect the potential return on investment and the degree of risk taken.
2. Choose from a range of investment alternatives:
  - Each of which is diversified
  - Each of which has materially different risk and return characteristics
  - Which in the aggregate enable the participant to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant
  - Each of which when combined with investments in other alternatives can minimize through diversification the overall risk of the participant's portfolio
3. Diversify the investment of his or her account so as to minimize the risk of large losses.

Most qualified defined contribution (DC) plans have interpreted 404(c) to mean that a diversified fund from each of the following asset classes should be offered: equity, fixed income, and capital preservation.

The Pension Protection Act of 2006 amended ERISA to provide a safe harbor for plan fiduciaries investing participant assets in qualified default investment alternatives (QDIA) in the absence of participant investment direction. A QDIA may be:

- Target retirement date fund;
- Balanced fund; or
- Professionally managed account.

In the spirit of ERISA, the Program could have a single default fund or a range of investments options with or without a default option.

### **Determining the number of options: comparable data**

Significant data is available for ERISA-qualified defined contribution plans with regard to participant behaviors and investment choices. We have chosen the broadest data set to reflect a range of employer sizes from micro to mega plans.

TABLE 1: NUMBER OF INVESTMENT OPTIONS IN ERISA PLAN, BY PLAN SIZE

All Industries/ Plan Size	Median number of investment options offered in a DC plan							
	2014	2013	2012	2011	2010	2009	2008	2007
Overall	19	17	16	16	18	17	16	16
Micro (<\$5MM)	20	18	16	17	18	18	16	17
Small (\$5 - <\$50MM)	19	18	17	17	18	18	17	16
Mid (\$50MM - <\$200MM)	18	16	16	16	17	17	16	15
Large (\$20MM - \$1B)	18	16	15	16	17	15	15	16
Mega (>\$1B)	15	15	14	15	16	15	n/a	n/a

*Source: Plan Sponsor Defined Contribution Survey (2010-2014)*

The number of investment options has ranged from 15 to 20 depending on the plan size and survey year. Plans with more than \$1 billion in assets typically have fewer investment options than smaller plans. Research has shown that limiting the number of options offered to participants can increase participation. Research conducted by professors at Columbia University and University of Chicago has shown that participation rates fall by 2% for every 10 options added to a plan.<sup>1</sup> Consequently, keeping the number of options limited is desirable.

<sup>1</sup> Source: Choice Overload and Simplicity Seeking, Sheena S. Iyengar, Columbia University, Graduate School of Business; and Emir Kamenica, University of Chicago, Graduate School of Business; February 2007.

TABLE 2: SURVEY OF INVESTMENT OPTIONS OFFERED

Typical Type of Funds offered in a 401(k) Plan	Plans with 5,000+ Participants	All Plans
Alternative Asset Class	3.2%	4.6%
Balanced Fund/Asset Allocation	34.4%	49.1%
Bond-Actively Managed, Domestic	82.8%	83.6%
Bond-Indexed, Domestic	57.0%	40.4%
Bond, International	12.9%	18.9%
TIPS	12.9%	8.1%
Cash Equivalents (CD/Money Market)	40.9%	47.4%
Company Stock	49.5%	22.1%
Emerging Markets	31.2%	37.2%
Equity-Actively Managed, Domestic	84.9%	88.9%
Equity-Actively Managed, International/Global	77.4%	84.1%
Equity-Indexed, Domestic	83.9%	80.9%
Equity-Indexed, International/Global	48.4%	31.8%
Real Estate Fund	17.2%	29.9%
Sector Funds(s) (Other than Real Estate)	12.9%	15.9%
Self-Directed Brokerage Window	40.9%	26.4%
Stable Value Fund	63.4%	59.6%
Target Retirement Date/Lifecycle Funds	69.9%	66.6%
Target Risk/Lifestyle Funds	9.7%	15.9%
Other	16.1%	12.7%

Source: PSCA's 58<sup>th</sup> Annual Survey of Profit Sharing and 401(k) Plans: Reflecting 2014 Plan Experience

The table shows the most prevalent investment options, highlighted in blue, available to participants in ERISA-qualified DC plan. These options are offered in more than 50% of plans. As the table shows,

most plans include: U.S. Equity, Non U.S. Equity, Domestic Fixed Income, Stable Value Funds, and Target Date Funds.

### **Investment design**

With the objectives of maximizing participation and retirement income, the investment design should align investment options to broad participant classifications, but allow choices without becoming overly complex. The CRSB should consider a default option for the “Do It For Me” participants accompanied by a simple, asset class line-up of funds for those participants wanting to make more active asset allocation decisions.

#### ***“Do It For Me” Default Option***

Default options that apply a lifecycle switching approach, referred to as target date funds, over the working life of the participant are widely used as a default option for “Do It For Me” participants. These default fund solutions adjust their asset allocation over time and do not require the participant to make investment decisions. Target date funds meet the needs of “Do it For Me” participant because:

- Target date funds are easy to communicate to participants;
- The risk profile is dynamic, offering an asset allocation solution that automatically adjusts as participant ages (i.e., participants do not need to manually rebalance their retirement portfolio as they near retirement);
- The participant has limited decisions (e.g., based on expected retirement date); and
- The fund usually includes more asset and sub-asset classes than what is typically available as standalone investment options, improving diversification opportunities.

#### ***“Help Me Do It” and “Leave Me To It” participant options***

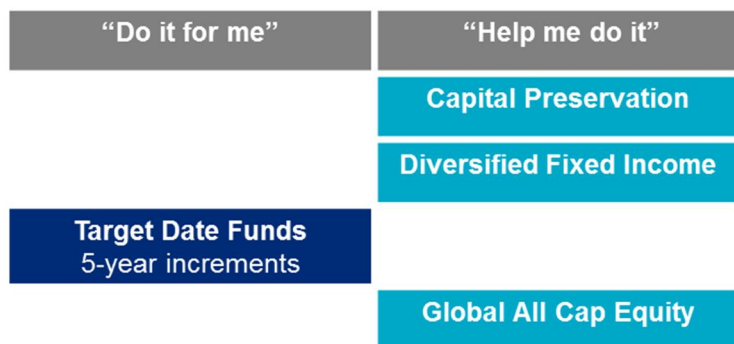
The other participant types want choices; however some guiding principles apply in designing the investments for these participants:

- Less is more: Too many options can be counterproductive, potentially providing participants with the “misery of choice” and discourage program participation.
- Sufficient risk-return variety should be provided: To manage program complexity and costs, investment options offered should generally be focused on those options that would be attractive to a majority of participants.
- Characteristics should be explainable to unsophisticated investor: Designing overly sophisticated solutions to cater for all the potential participants’ needs is tempting; however participants should understand their investments and the role they play in retirement savings.

If the CRSB decides to recommend some investment choice within the Program, Mercer recommends having broad asset class based funds in addition to target date funds. Specifically, Mercer recommends including: capital preservation (e.g. stable value funds if feasible to offer within the Program or a money market fund), diversified fixed income, and global all capitalization equity. An

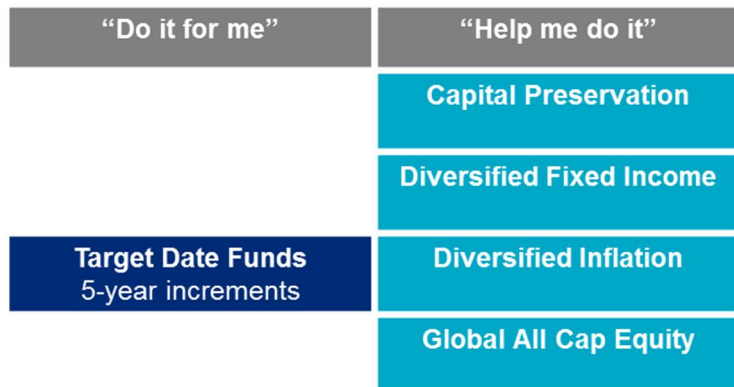
individual interested in building their own retirement portfolio can effectively do so using these three broad asset class exposures.

#### EXAMPLE 1: RECOMMENDED INVESTMENT DESIGN



An alternative approach is to add inflation protection into the fund options.

#### EXAMPLE 2: ALTERNATIVE APPROACH



### Passive versus active management

The future governing and managing bodies will need to decide whether to offer passively or actively managed funds or a combination. From an asset management fee perspective, the costs of passive funds are significantly lower than active fund, so using active funds will have an impact on the total participant fees. Because costs and returns have a big impact on savings accumulation, this decision will affect the financial feasibility and achieving policy goals. While the decisions may be left to the bodies implementing the program, the CRSB may want to express an opinion on these elements.

### Next Steps

Based on the CRSB's feedback, Mercer can provide more information on the range of investment solutions that can be offered as a default investment in the Program. In addition, Mercer can provide

additional information on other investment options that the Program can offer if the CRSB decides to offer recommendation on this to the legislature. In a future memo, Mercer will discuss annuity solutions that meet the statutory requirements and address the issue of improving income replacement ratio in retirement.

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