It's All About the Beneficiaries

Fiduciary Best Practices in Target Date Funds

October 27, 2010 Webinar
2:00 pm EST

Agenda: Theory and Practice

- **Fiduciary responsibilities and DOL/SEC guidance**
  Rich Lynch, COO, Fi360
- **Best practices (substantive prudence) objectives and policies**
  Ron Surz, President, Target Date Solutions
- **Practical implications from a co-fiduciary's perspective**
  Matt Gnabasik, President, Blue Prairie Group
- **Advantages of CITs for QDIAs**
  David Hand, CEO, Hand Benefits & Trust

Fiduciary Overview

- Pension Protection Act established QDIA “Safe Harbor” protection (August 2006)
- Associated DOL Regulation effective (December 2007)
- Two Fiduciary Practices Apply:
  - Practice 3.2 Safe Harbor (optional)
  - Practice 3.1 Investment/Manager Selection

SEC/DOL Guidance

Joint DOL/SEC Hearing held in June 2009 generated three initiatives:

1. Target Date Retirement Funds (TDFs) Investor Bulletin – May 2010
   - http://www.dol.gov/ebsa/pdf/TDFinvestorbulletin.pdf
   - TDF Fund Basics
   - Evaluating a TDF

SEC/DOL Guidance (continued)

2. SEC Proposed Rule – June 2010
   - www.sec.gov/rules/proposed/2010/33-9126fr.pdf
   - Addresses concerns about TDF advertising and marketing
   - Comment deadline – August 2010
   - 53 comment letters received
   - More disclosure will be required

SEC/DOL Guidance (continued)

3. Fiduciary Best Practice Checklist
    - Should be finalized and released in 2010
    - Guidance to plan sponsors regarding how to evaluate and select TDFs

It’s as Simple as P-O-P-P

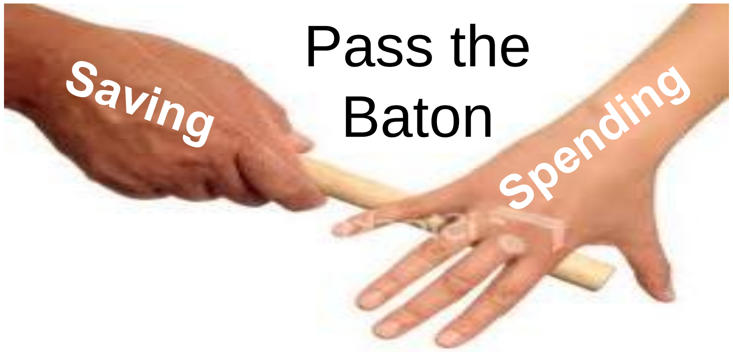
Separating the Wheat from the Chaff

- **P**rudence
- **O**bjectives
- **P**olicies
- **P**erformance

P-O-P-P: Prudence

Arrive Safely at Target Date

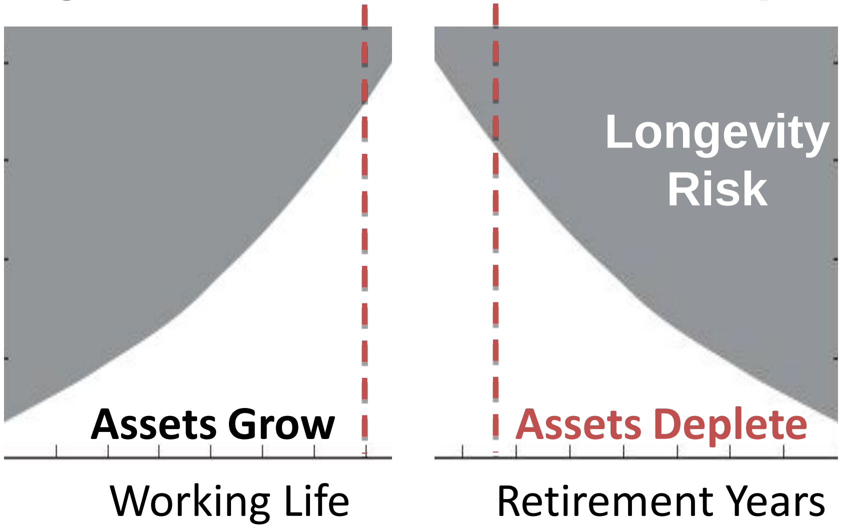
Beyond the Target Date is Another Story



With REAL "To" funds, someone needs to make a decision during the Transition Phase (Risk Zone)

Wheat

Accumulation



Chaff

(No glide path can manage longevity risk)

Distribution

Annuities, Guaranteed Payouts, etc.

P-O-P-P: Objectives

Wheat

1. Deliver at least accumulated contributions plus inflation at target.

2. Grow assets as much as possible without jeopardizing the above objective.

Chaff

Neither longevity risk nor pay replacement can be managed by a glide path.

Because

One-size-fits-all investments bear no relationship to savings or mortality

P-O-<u>P</u>-P: <u>P</u>olicy

Wheat

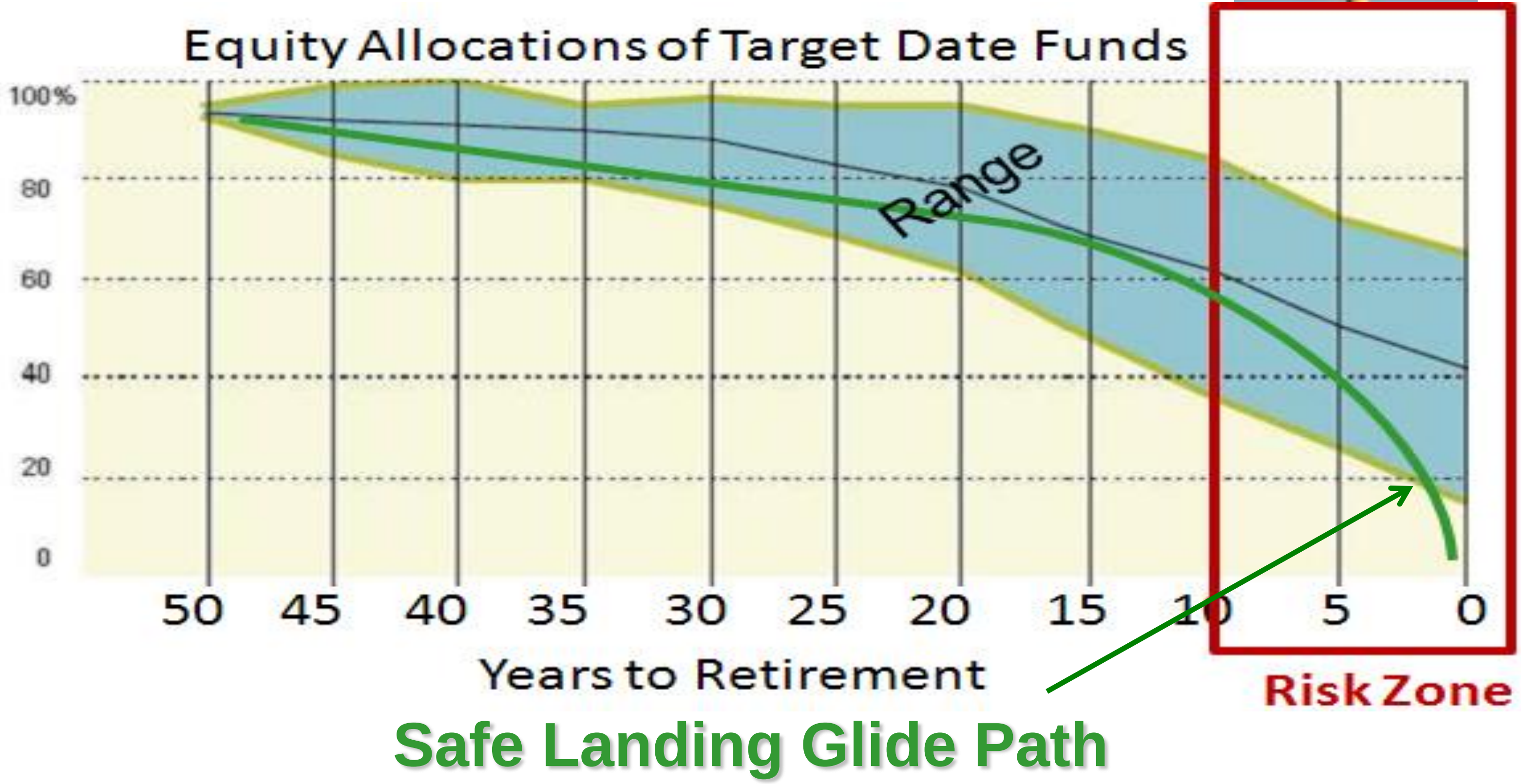
1. Accumulation only is the best policy. A <u>real</u> “To” fund ends at target date.
2. A financially engineered glide path strives to achieve the **<u>O</u>**bjectives.
3. Good risk-adjusted performance occasionally sacrifices opportunity.
4. Economical fees increase savings.

Chaff

1. To-Through is a farce because they’re all “Through” (Flat “To” is “Through”).
2. Open-closed architecture pales in importance to asset allocation/glide path.
3. Performance relative to peers doesn’t matter. Relative to risk matters.

P-O-P-P: Policy (continued)

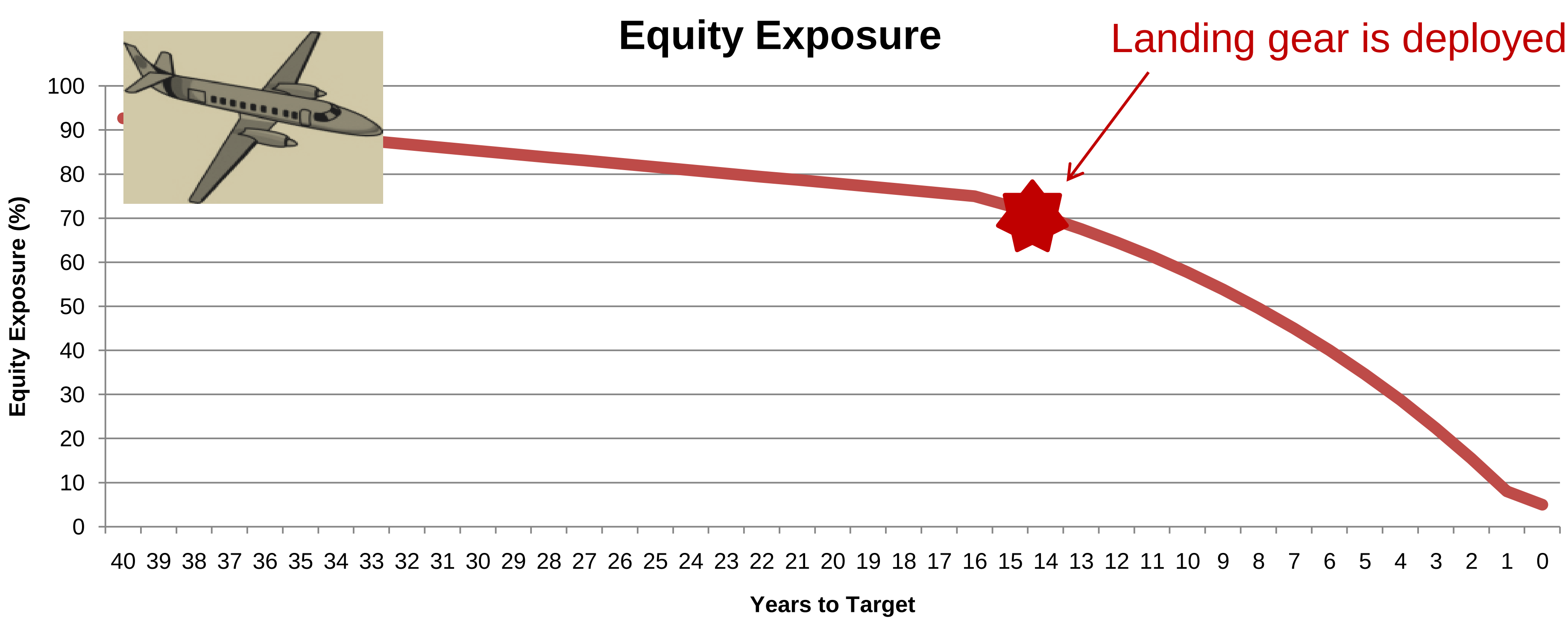
Current Industry Glide Paths disagree on P-O-P-P with each other and the Safe Landing Glide Path®



P-O-P-P: Policy (continued)

If we can agree on the destination (**safety first at target date**), let's discuss the best way to get to where we're going.

Glide Path



P-O-P-P: Policy (continued)

Two Separate, Well-Diversified Portfolio Segments for (1) Growth and (2) Safety

Liability-Driven Investing

1. The World Market Portfolio

Designed to provide ***growth potential*** in early years

- Broad diversification
- US stocks and bonds, Foreign stocks and bonds,
- Global real estate and commodities, Opportunistic
- Mostly passive

P-O-P-P: Policy (continued)

Two Separate, Well-Diversified Portfolio Segments for (1) Growth and (2) Safety

Liability-Driven Investing

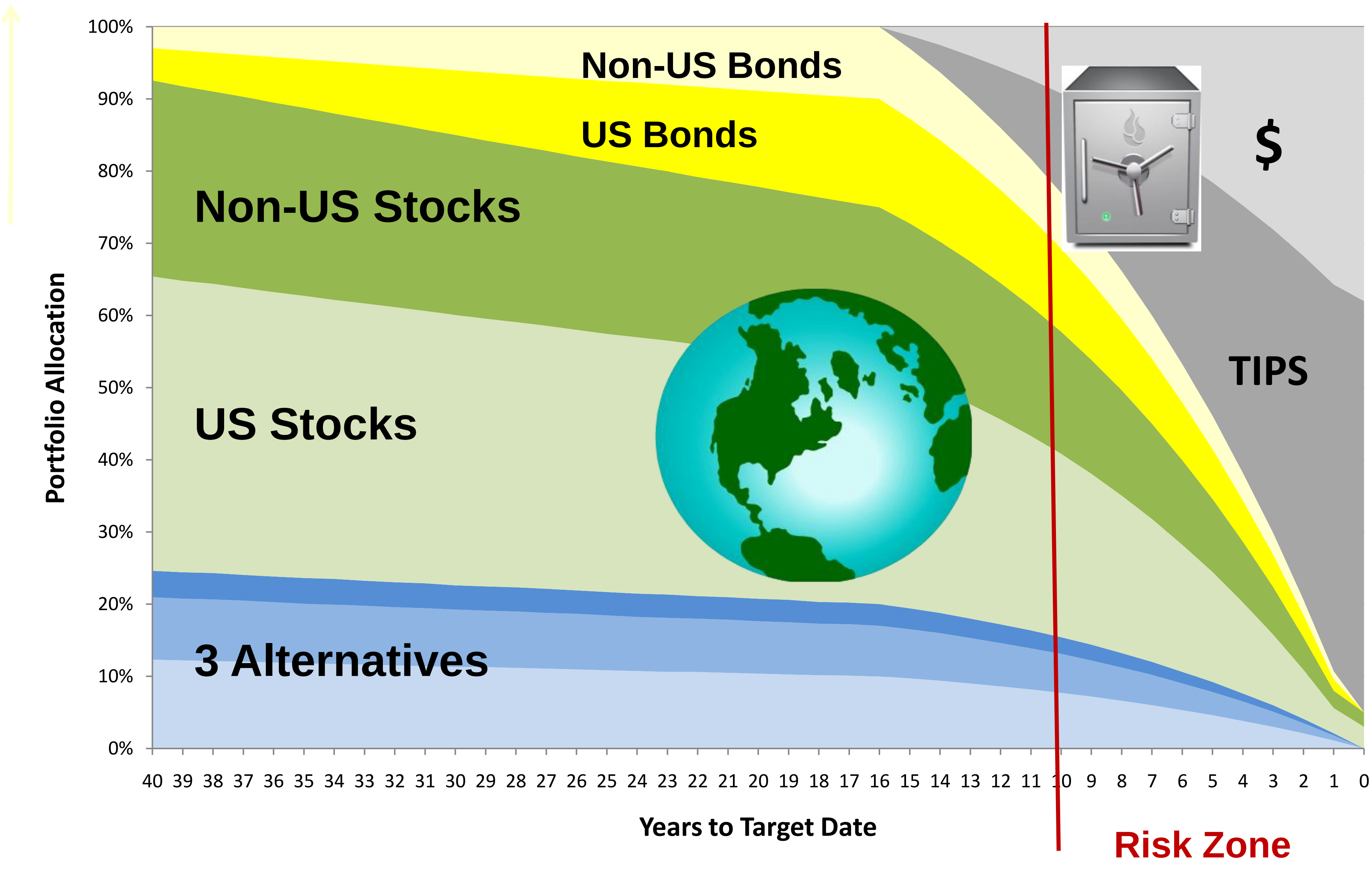
2. The Reserve Portfolio: 15 years from target

Designed to ***preserve assets*** as retirement nears

- Treasury securities to mitigate credit risk
- TIPS to protect against inflation
- Lock box discipline avoids whipsaws

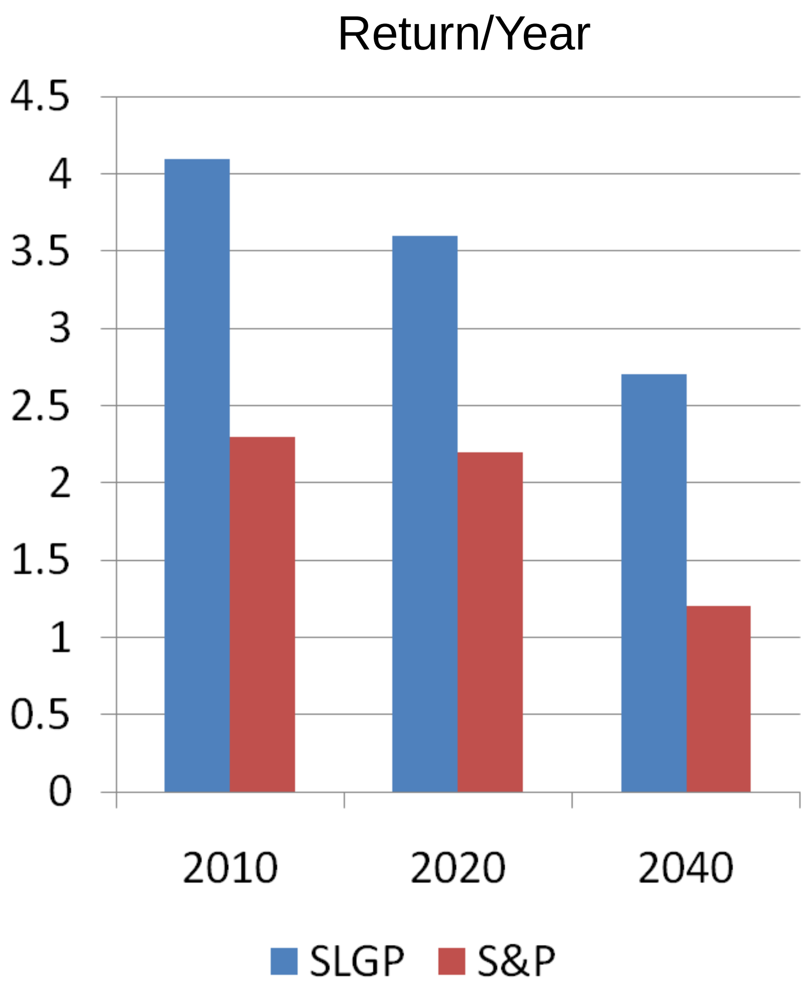
P-O-P-P: Policy (continued)

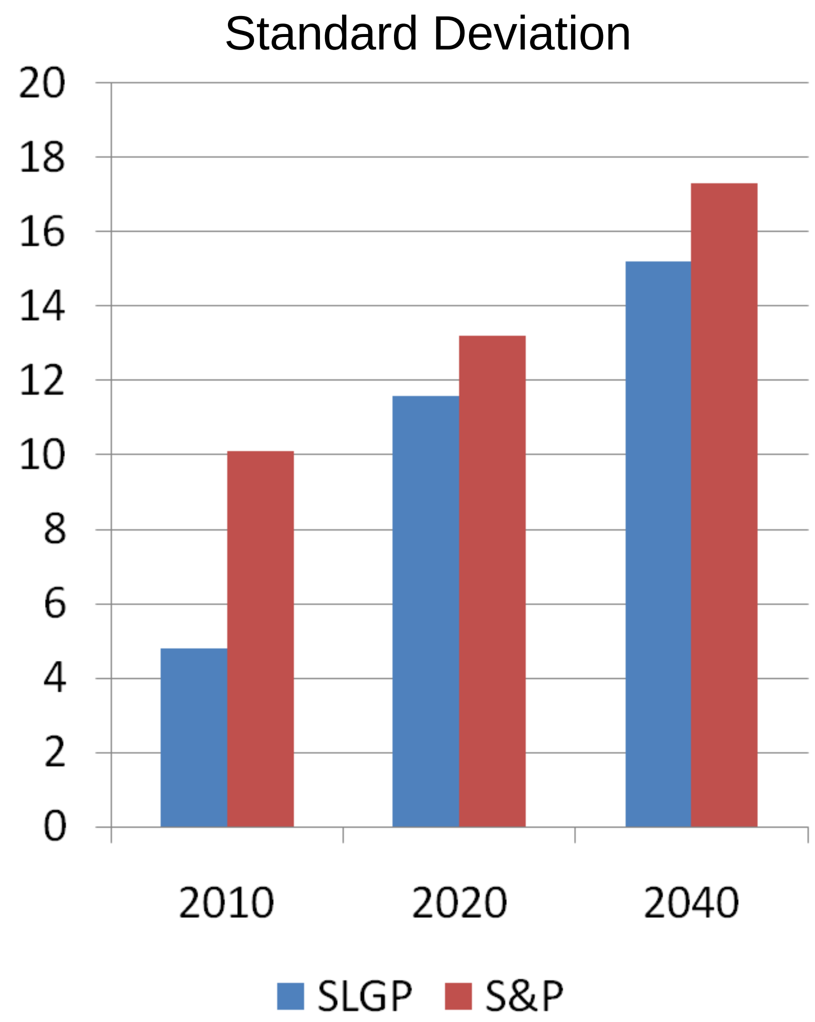
Safe Landing Glide Path



P-O-P-P: Performance

5-Year Return and Risk through 9/30/10





SLGP is Engineered to P-O-P-P

Prudence: First, lose no money.

Objectives:

- Deliver at least total contributions + inflation at target
- Grow assets without jeopardizing safety at target

Policies:

- Accumulation only, end entirely in safe inflation-protected assets
- Financially engineered curvilinear glide path with lock box
- Separation Theorem with world-wide diversification

Performance:

- Defend near target
- Diversify growth portfolio

What’s Going On in Target Date?

- PPA created a boom in target date funds; DOL established them as QDIAs in ‘07
  - Fiduciaries are not liable for losses which occur as a result of participants being defaulted into target-date funds
- Over the next 5 years, target date funds are projected to capture $1.7 trillion in flows and account for 60% of DC assets and revenues
- Innovation has started
  - Custom target date solutions for large and mega plans
  - Semi-customized multi-manager products
  - Predominantly passive for small plans

Fiduciary Concerns and Target Date

- Most were designed primarily as accumulation vehicles (most fail to meet clients' needs for income, capital preservation and inflation protection)
  - Asset managers make more money on equities compared to fixed income and active management over passive management

Fiduciary Concerns and Target Date (continued)

- If the plan sponsor is unhappy with any aspect of the management of the single-manager fund, there is nothing the sponsor can do. And this is particularly problematic in single-company offerings where Target Date funds are little more than an asset gathering tool.

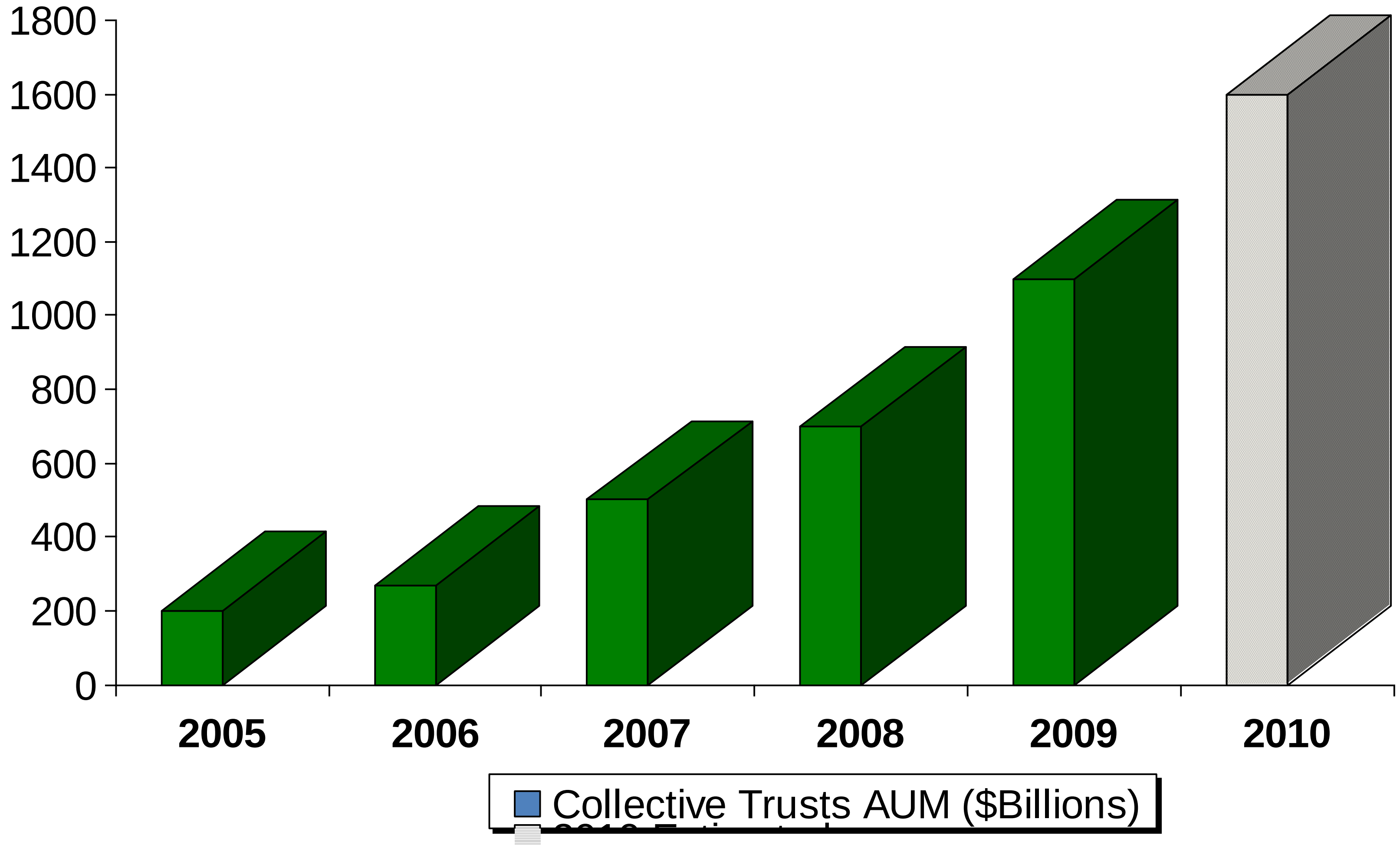
- Selecting a single-manager target date fund does not relieve fiduciaries from the responsibility of evaluating the quality of asset-allocation providers or managers and strategies in the underlying asset classes.

How to Evaluate a Target Date Product

- Start with most basic design point: “through” or “to”
- Glide Path: How refined are the asset classes used in designing the portfolio?
- Look at each of the underlying managers: single family of multi-family?
- Cost structure: high, low or average?

Advantages of CITs for QDIAs

Growth of Assets Under Management in CTF's



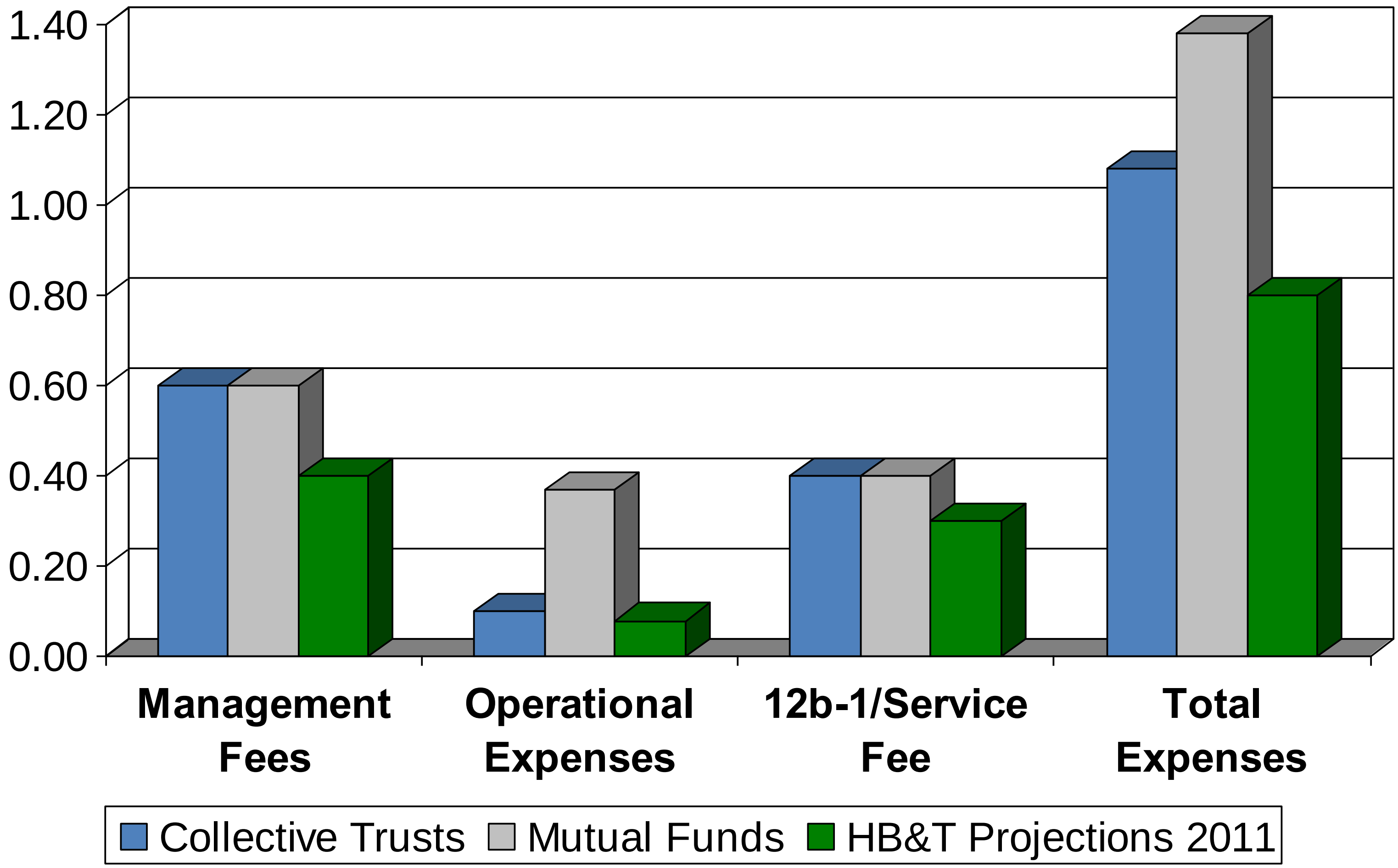
Advantages of CITs for QDIAs (continued)

CTF vs. Mutual Fund Characteristics

Item	Collective Funds	Mutual Funds
Costs	Lower	Higher
Share Class	Multiple Fee Classes	Multiple Share Classes
New Share Classes	Easy to open –quick turnaround	Expensive and time consuming
Private Label	Easy	Difficult
Tracking	Morningstar	Morningstar, Newspapers
Redemption Fees	No	Yes
Trading Restrictions	No (some GIC & other assets)	Yes
NSCC Trading	Yes (daily value, T-1)	Yes (daily value, T-1)
Open to Non-Qualified Investors	No	Yes

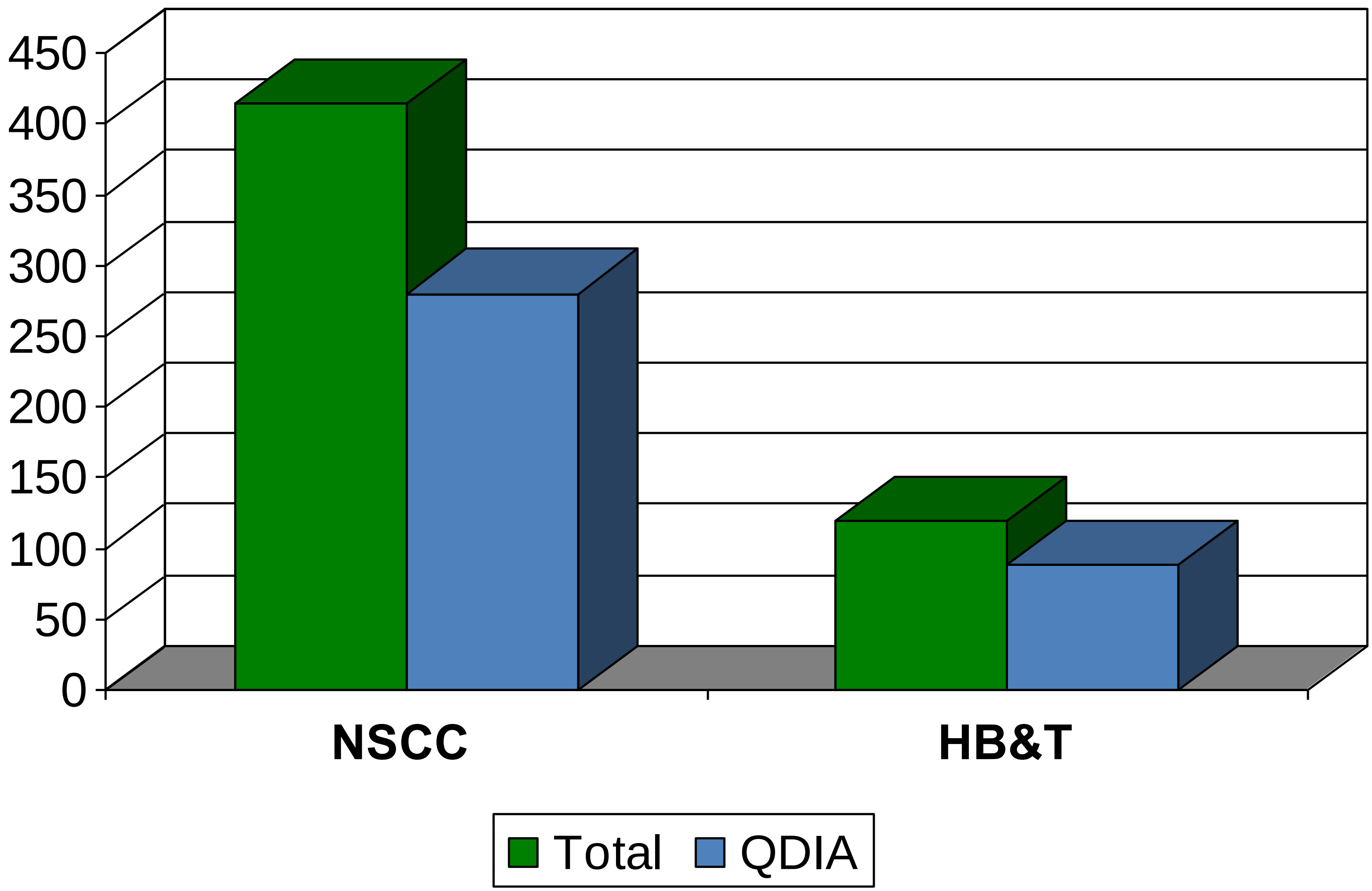
Advantages of CITs for QDIAs (continued)

Average Fees for CTF's vs. Institutional Large-Cap Equity Mutual Funds



Advantages of CITs for QDIAs (continued)

New Collective Trusts vs. QDIA CTF's



Advantages of CITs for QDIAs (continued)

- Lower cost structure
  - Operating cost (audit, compliance, distribution, etc.)
  - Impact cost (trading cost, cash, small retail investors, market timing)
- Fiduciary advantages; CTF is “direct” fiduciary to plan with contract participation agreements
- CTF’s are often a recordkeeping solution vs. “model portfolio” on 401(k) menu

Advantages of CITs for QDIAs (continued)

- No minimum asset requirements by plan
- Transparency in fund holdings, fees and investment policy statement
- Flexibility on underlying assets like alternative asset classes

Summary

1. The key decision is Safety or Growth.
2. Investment managers are mostly providing "Growth" products. Profits are a probable reason.
3. The distinction between "To" and "Through" funds has been blurred.
4. Plan sponsors are responsible for selecting and monitoring. Convenience and familiarity with the plan's recordkeeper are not suitable criteria.
5. The Safe Landing Glide Path® exemplifies a good target date fund glide path.

Contact

For more information, contact

HAND Benefits & Trust a BPAS Company

David Hand, CEO
Hand Benefits & Trust Co.
820 Gessner, Suite 1250
Houston, TX 77024

(713) 939-4080
dhand@bpas.com

http://www.bpas.com/about_us/hand_trust_company.htm