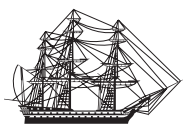
VANGUARD COMMENTARY

Considering custom for your DC plan

May/June 2018

Authors: Michael Palazzi, CFA, CFP® • James Martielli, CFA • John Croke, CFA



Vanguard®

Executive summary

As defined contribution (DC) plans represent a growing share of U.S. workers' retirement nest eggs, plan sponsors and consultants may be considering customized investment options for their DC plan investment menus. This commentary discusses the potential benefits and drawbacks of including nonstandard investment options, particularly white-label funds, in a 401(k) plan.

As with all investment plan decisions, the choice to use standard, off-the-shelf investment portfolios or adopt customized investments is a fiduciary one that should be made in the best interests of plan participants. While the degree of fiduciary involvement by plan sponsors or their agents generally grows with customization, we believe it's worth taking a closer look to ensure plan sponsors and consultants fully appreciate the potential merits of such an approach.

So, does customization provide potential benefits to plan participants that outweigh any additional responsibilities and costs assumed by the plan sponsor?

Ultimately, the choice between a standard investment vehicle and a customized solution involves a series of tradeoffs and depends on a plan sponsor's unique situation, objectives, and preferences. We offer three areas of focus for plan sponsors considering a nonstandard investment approach for a DC plan:

- **Consolidation** of investment options may make investment menus easier for participants to navigate. Reducing the number of choices and simplifying naming conventions may drive more favorable participant outcomes. The plan's participant population might have certain demographics or risk tolerances that may warrant a unique investment vehicle.

- Customization also gives plan sponsors more **control** over the investment vehicle's design. The plan sponsor may have specific investment beliefs requiring allocations to certain asset classes or manager strategies that are meaningfully different from those available from standard offers. This can potentially result in better returns and lower risk that can benefit participants over the long run.

- With more control, plan sponsors with significant scale may leverage lower pricing. Lower **cost** is one of the most powerful tools for the fiduciary working to improve outcomes for participants. As they pay less in fees, they have more to keep and invest. Ultimately, plan sponsors must decide how they want to spend their "fiduciary budgets." A major consideration is the all-in price of customization.

Plan sponsors who want to pursue a custom investment solution need the time, will, and ability to oversee unique plan-specific offerings. Without the in-house capability, they need to hire individuals—consultants, investment managers, administrators—to handle the process for them. That does not mean, however, that customized solutions should be dismissed outright based on the resources required if the sponsor believes that these vehicles can serve the best interests of participants.

Finally, independent of the investment vehicle choice, sponsors must also consider other critical strategies available to improve retirement outcomes for participants, including increasing contributions to the plan, minimizing early withdrawals, and reducing all-in plan fees. These strategies typically have more influence on participant outcomes than changes to a target-date fund (TDF) glide path or the creation of a white-label fund. Failing to address these other elements of retirement readiness may offset all, or part, of the benefits associated with a custom strategy.

Introduction

What are white-label funds?

White-label funds are generally packaged investments branded by asset class or objective. White-label fund names may reflect their asset class or objective, but unlike standard funds, in most cases they do not reference a specific fund company. White-label funds are generally structured as re-unitized funds of funds.

A unitized fund pools funds to invest with individually reported unit values for investors. They take multiple underlying investment strategies, combine them into one fund, and strike a daily NAV (net asset value) at the overall portfolio level. Plan sponsors and consultants are also applying white-label concepts to TDFs to create custom TDFs. These funds are basically white-label funds with glide paths. Their underlying investment strategies and glide paths are tailored at the plan level.

Types of white-label funds

- Single-manager
- Single-asset class multimanager
- Multiasset class multimanager
- Custom TDFs

Although the conversation about custom investments in DC plans is broader today than ever, these less traditional approaches to building DC investment solutions have actually been around for quite some time. In fact, many employee stock and stable value strategies are essentially white-label funds and have been around for decades. Plan sponsors and consultants may believe that presenting sophisticated portfolio construction in an easy-to-understand package can help contribute to better long-term outcomes for plan participants. While we maintain that white-label solutions could be a reasonable fiduciary choice depending on a plan sponsor's objectives, there are pros and cons for each. As a plan sponsor, it's important to learn all you can so you can thoroughly analyze and document your decision process.

Analyzing custom glide paths

Glide paths differentiate custom TDFs from other white-label funds. Practically speaking, the glide path is the participants' asset allocation as they move through their life cycle. Studies show that the most important determinant of any portfolio's return behavior is its asset allocation.* When considering a custom approach to TDFs, plan sponsors should compare their participant population with the underlying assumptions made by their TDF provider. Are the demographics similar or different? If they differ, are those differences significant? The sponsor may consider customizing the glide path to accommodate the unique needs of the population.

For example, a TDF designer might assume that a higher-paid or better-educated participant population is better able to assume investment risk at a given age. A factor like the relative generosity of participant or employer contributions might also have a varying impact, depending on interpretation of the data.

A related factor that could influence glide path design is other portfolio holdings. For example, the influence of a defined benefit (DB) plan and corresponding pension payment may vary depending on the TDF designer's assumptions.

In fact, a recent survey by Callan Associates found that in 2017, 52% of plan sponsors evaluated the suitability of the glide path for their participant population.** While sponsors have evaluated glide path suitability, Vanguard has not observed plan sponsors opting for custom TDFs based on demographics alone. Instead, sponsors are opting for custom TDFs based on asset class preferences and the role active management can play in potentially improving participant outcomes.

Vanguard recognized the need to have a rigorous analytical framework for quantifying and documenting the expected benefits from customization. In today's environment, you need more than conviction. You need supporting evidence. Vanguard created a proprietary tool, Glide Path Solutions™ (GPS), which is powered by our Vanguard Life-Cycle Model (VLCM)*** to enable sponsors and consultants to assess these distinguishing features.

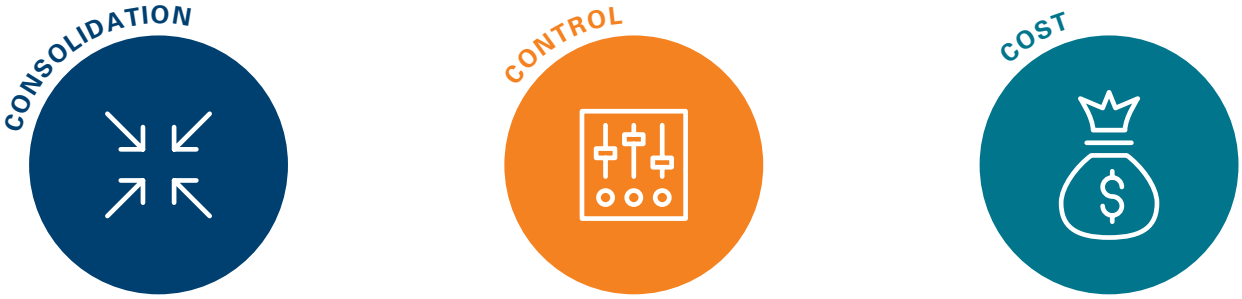
* Brinson, Gary P., L. Randolph Hood, Gilbert L. Beebower, 1986. "Determinants of Portfolio Performance." *Financial Analysts Journal*.

** Callan Institute survey: 2018 Defined Contribution Trends.

*** Aliaga-Díaz, Roger, Harshdeep Ahluwalia, Kevin DiCiurcio, Matthew C. Brancato, 2016. *Vanguard Life-Cycle Investing Model: A framework for building target-date portfolios*. Valley Forge, PA: The Vanguard Group.

Figure 1. Benefits and challenges to consider

	Benefits	Challenges
Broader diversification	• Multimanager structure diversifies management and style • Provides access to asset classes that may not be suitable as a stand-alone fund	• Increases complexity of oversight • "Alternative" asset class exposures may require expertise in selecting active managers • May not make a material difference in altering risk/return profile
Optimize participant decision-making framework	• Simpler naming convention may help to minimize portfolio construction errors	• Transparency—customized solutions may not come with historical track record • Little access to data from public source (fund company website, Morningstar)
Tailored asset allocation	• Asset allocation plan may be tailored to plan demographics	• Transparency—customized solutions may not come with historical track record • Little access to data from public source (fund company website, Morningstar)
Fiduciary implications	• Plan sponsor may lever co-fiduciary or fully outsourced fiduciary for expertise • May allow plan sponsors ability to focus on "bigger picture" items	• Outsourcing does not eliminate responsibility, "mitigation not absolution"
Costs	Depends on your starting point!	



Consolidation of menu options

Over the past few years, plan sponsors have evaluated their options for optimizing their DC plan investment menus. Many plan sponsors have chosen to tier their investment lineups and offer qualified default investment alternatives (QDIAs) to help plan participants with the decision-making process. Along with the growing prevalence of low-cost index tiers, we've seen participant cash flows consolidating within a smaller subset of investment categories, such as TDFs and index funds.* This consolidation potentially leads to a greater benefit from customization, as assets are less dispersed across menus than they were a decade ago.

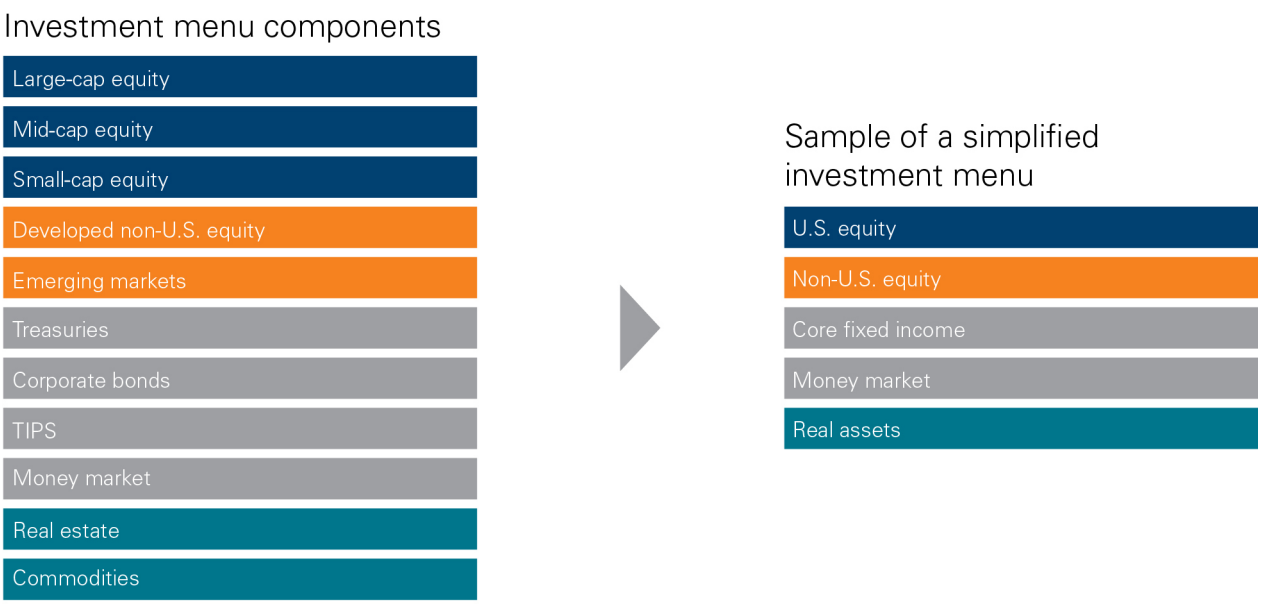
White-label funds, either managed in-house or outsourced, provide one opportunity to streamline the DC investment menu. Through thoughtful white-label design and implementation, the sponsor may consolidate multiple investment strategies into a single, broadly diversified option that provides significant exposure to the desired asset class.

As an example, a plan may offer actively managed investment vehicles across the market-cap spectrum within U.S. equities. This may be accomplished by offering separate large-cap, mid-cap, and small-cap strategies. However, a white-label option can allow the flexibility to consolidate these three offerings into a single active domestic equity portfolio. (See Figure 2.) Some plan sponsors opt to consolidate their menus by simply eliminating options that are similar. Both approaches are consistent with a "less-is-more" philosophy.

Not only do participants likely stand to benefit from a consolidated investment menu, but white-label options can potentially improve naming conventions. This will hopefully make it easier for participants to understand a fund's investment strategy. Remember that while many off-the-shelf fund names may not offer a straightforward naming convention, this is certainly not true in all cases. Most passively managed index funds offer very clear naming conventions, which describe their underlying investment strategies.

* Source: *How America Saves, 2017*, Vanguard.

Figure 2. Consolidation of investment options



Control of investment design and oversight

White-label portfolios give plan sponsors more control over their plans. In a standard investment vehicle, all aspects of fund accounting and custody are handled by the fund provider or by a third party selected and monitored by the fund provider.

Customization enables the plan sponsor to create a plan that reflects the unique circumstances, beliefs, and demographics of its own employees. We recognize that plan sponsors may have distinct views about portfolio construction or manager selection in a multiasset portfolio. These preferences may or may not be consistent with standard TDFs.

For example, perhaps a plan sponsor has a preference about the underlying fixed income exposure within their plan. The plan sponsor may want an overweight to investment-grade or high-yield corporate bonds rather than high-quality Treasury and sovereign bond exposures. Customization of a fund allows the plan sponsor flexibility to develop and control a portfolio that most closely aligns with their investment beliefs.

While strong investment beliefs can be a motivator to consider customization, sponsors should evaluate whether these beliefs are long term and strategic in nature or reflect a more short-term view of market conditions. The sponsor will also have to decide how these sub-asset allocations will shift over time. When choosing a standard offering, these decisions are ultimately outsourced to the asset manager who has a core competency in these areas.

The flexibility to tap specialized options

Customization offers flexibility in implementation that is all index, all active, or a hybrid combining the two. Unlike off-the-shelf investment options, which primarily consist of proprietary offerings managed by the investment provider's in-house staff, customized options can tap specialized managers in different asset classes, potentially increasing the opportunity to add value.

Unique to white labels, this open architecture framework combines multiple managers and asset classes into a single portfolio. It offers potential benefits from exposure to alternative investment types that may not be appropriate as a stand-alone investment offering in a DC plan.

The trend toward unbundling of recordkeeping and investment menus is also evidence that plan sponsors want more control. However, with control comes additional responsibilities. With white labels,

not only does the plan sponsor need to ensure all administrative functions are fulfilled, but the plan sponsor also has to design the portfolio or, if they find it worthwhile, hire a third-party fiduciary to perform these functions. Plan sponsors have differing views about their responsibilities to plan participants. That said, we are seeing a growing sense of paternalism among plan sponsors—particularly those that have undergone the closing and/or freezing of a DB plan.

Customized communications

In addition, given the goal of white-label options to simplify fund names and improve the investing experience for the end participants, it's important that plan sponsors consider the associated education and communication needed for white-label implementation. This can be viewed as both an opportunity and a challenge.

Standard funds and collective investment trusts come with a track record of performance and, in most cases, sources of information where plan participants can go to research the desired portfolio. Choosing a white-label option may make it more difficult for participants to find information about the underlying portfolios. Plan sponsors who choose white-label funds will need to create or outsource a comprehensive participant communication and education program to support participants.

Administrative oversight

Beyond the fiduciary oversight, custom investment vehicles require substantial administrative responsibilities. With standard investment vehicles, the offering fund company seamlessly handles these administrative responsibilities.

Plan sponsors creating a white-label fund or customized target-date investment may—depending on the structure of the investment—need to arrange for a variety of services including:

Figure 3. Unbundled custom portfolio administration

Category	Operational considerations
Participant communications	An educational strategy that reflects the custom portfolio approach may need to be developed either with in-house resources or the help of a third party.
Participant reporting	Basic reporting to participants may be needed, including portfolio goals, strategy, glide path, and performance. This is usually presented in print (PDF) as fact sheets and electronically on the web or on mobile devices.
Security valuation	If a custom portfolio includes holdings not registered under the 1940 Act, without a daily share value embedded in a product, a pricing agent is needed to execute and value the security.
Pricing	A custom portfolio requires that an NAV is struck daily, at the fund of fund and underlying fund level, and is transmitted to the recordkeeper on a timely basis.
Custody	The plan sponsor or a third party must receive sub-fund level trading instructions from the transfer agent, wire cash to and from appropriate sub-funds, and may need to strike a daily blended NAV for each fund.
Plan sponsor reporting	Includes total return performance and other portfolio metrics at the fund of fund and underlying fund levels. In addition, the development of customized benchmarks may be needed.
Transition management	A suite of services designed to "transition" assets from one investment to another will be needed to minimize transaction costs, provide liquidity, ensure compliance with rules and regulations, manage investment constraints, minimize market impact, and design and execute the communications strategy.

Source: Vanguard analysis.

Costs and benefits of custom implementation

As with any fiduciary decision, it's important for plan sponsors and consultants to weigh potential benefits against the added costs and responsibilities when assessing whether or not to build a plan using white-label funds. Ultimately, plan sponsors must consider their organizational readiness and decide how they want to spend their "fiduciary budgets" in terms of the all-in fees for fund administrative services. These include both direct and indirect fees associated with portfolio customization. Can the sponsor achieve cost-effective benefits by implementing white-label funds, or will using standard mutual fund or collective investment trust (CIT) vehicles with lower all-in costs be a more prudent choice?

It's important for sponsors and consultants to consider their ability and desire, not only to select multiple asset managers, but to also oversee those managers. This may offer the opportunity to harmonize oversight work already in place for a DB plan. But that is not the case for all plan sponsors.

The typical inventory of direct costs will include fees for plan design and management, day-to-day investment management, investment administration costs, and costs for customization of the participant experience. There may also be consultant fees associated with a fund design. In addition, there are indirect costs associated with fiduciary oversight and monitoring. All of these costs vary with the complexity of the design and implementation. A customized investment option is individualized to the plan; therefore, economies of scale will be lower than for standard offerings.

Some very large DC plans may be able to spread costs over a larger asset base and save on costs by using a customized TDF series or white-label fund.

But for most plans, customized options cost more than a standard option. That means that the potential incremental return must be greater than the costs. Some plans may find it worthwhile to outsource the additional costs of customization to a third party. Callan Associates 2018 DC trends survey indicates that 92% of plans offering unitized or "private label" funds have plan assets in excess of $1 billion; more than half have assets greater than $5 billion (52%).*

The impact of plan design

The choice of investment vehicles in a DC plan should be made in concert with other elements of plan design to maximize the odds of investment success for plan participants. For plan sponsors, the question of using a standard or a custom portfolio is important; however, it isn't the most impactful component of plan design. Other steps can be taken to increase participants' chances for meeting retirement goals. A plan sponsor may focus on two other key elements:

- Low-cost solutions, which help investors keep more of any return their portfolios earn.
- Encourage savings through autoenrollment, autoescalation, and education.

We find that savings and cost strategies have more of an impact on probable outcomes than glide path changes.** These factors can have a relatively large impact on plan participant outcomes—and, unlike investment performance, are within the control of plan sponsors and plan participants.

* Callan Associates, 2018.

** Aliaga-Díaz, Roger, Harshdeep Ahluwalia, Kevin DiCiurcio, Matthew C. Brancato, 2016. *Vanguard Life-Cycle Investing Model: A framework for building target-date portfolios.* Valley Forge, PA: The Vanguard Group.

Conclusion: Consider the three Cs

As we've discussed, it's important for plan sponsors to let their goals for their plans drive their decision-making process. What goals are being pursued? Is the potential disruption to your plan worth the potential reward? Given the participant population and corporate circumstances, is choosing a customized portfolio for a DC plan investment option going to improve participant outcomes? Materiality is an important consideration.

Perhaps **consolidation** of investment options will simplify investment selection and drive a more favorable participant outcome. In considering a customized approach relative to a pared down investment menu or a low-cost passive alternative, plan sponsors should observe quantitative and qualitative benefits that can be reasonably expected to offset incremental costs. Investment outcomes might be measured by the ability of an assumption to alter the risk/return characteristics of the portfolio over time. Retirement outcomes might be measured by how the assumption influences retirement preparation at retirement age or throughout retirement. Depending on the current structure of a sponsor's plan menu, the participants may or may not experience the perceived gains of a customized approach.

How much **control** does the plan sponsor want to have over the plan? How important is it that the plan reflect a company's circumstances, investment beliefs, and the demographics of its employees? A customized investment option may be preferable to a standard TDF or fund if it offers a reasonable chance of material improvement for investor outcomes and the plan sponsor and investor base in question display homogenous qualities and beliefs that differ from the broad population.

Finally, should an organization take on the added responsibility of custom investments or outsource them? Are the relative **costs** of customization offset by incremental quantitative and qualitative participant benefits?

While it's true that the level of fiduciary participation by plan sponsors or their agents is generally greater with customization, we believe it's an important part of due diligence to consider custom options. A close look is required to fully understand the potential merits of such an approach within the context of a specific plan. Each plan is unique and deserving of careful analysis and expert consideration.

Vanguard can help. Talk to us about your plan. We can help you evaluate and implement a customized approach if it is right for you and your employees.

References

Aliaga-Díaz, Roger, Ph.D., Harshdeep Ahluwalia, M.Sc., Kevin DiCiurcio, CFA, Matthew C. Brancato, CFA, CPA, *Vanguard Life-Cycle Investing Model: A framework for building target-date portfolios*. September 2016, Valley Forge, PA: The Vanguard Group.

Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower, 1986. "Determinants of Portfolio Performance." *Financial Analysts Journal* 42(4).

Callan Institute survey: 2018 Defined Contribution Trends. Callan Associates, 2018.

Young, Jean, 2017. *How America Saves 2017*. Valley Forge, PA: Vanguard Center for Retirement Research, The Vanguard Group.

P.O. Box 2600
Valley Forge, PA 19482-2600

Connect with Vanguard® > institutional.vanguard.com > 800-523-1036

Vanguard research >
Vanguard Center for Retirement Research
Vanguard Investment Strategy Group

E-mail > research@vanguard.com

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments (stocks) to more conservative ones (bonds and short-term reserves) based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

All investing is subject to risk, including the possible loss of the money you invest. Diversification does not ensure a profit or protect against a loss.

The information presented in this paper is intended for educational purposes only and does not take into consideration your specific circumstances or other factors that may be important in making investment decisions.

CFA® is a registered trademark owned by CFA Institute.

CUSTPRBR 062018 DOLU 11212019