The evolution of retirement investing:

a closer look at personalized strategies

Today, a majority of retirement plan participants (56 percent) use some form of professionally managed offering, with Millennials more likely to use such accounts (63 percent) then Generation X (48 percent) or Baby Boomers (54 percent).[1] In the retirement space, most managed portfolios include Target Date Funds (TDFs) and Retirement Managed Accounts (RMAs). There are pros and cons to both, and TDFs have certainly grabbed headlines, as well as a substantial amount of retirement plan assets; however, by today's standards they are falling behind. TDFs are under pressure from RMAs, which offer a more personalized investment solution that has a better chance of meeting the retirement income needs of each plan participant – and appeal to younger generations that demand customized experiences and results in this digital age.

The original "personalized" offering – TDFs

TDFs are diversified portfolios that follow defined asset allocation models. Investment providers offer a series of these portfolios with each having an asset allocation based on a different "target" retirement date, such as 2025, 2030, 2040, etc. As the target date approaches, the investments automatically rebalance to be more conservative (i.e., move from equities to bonds). The management of that shift is the fund's "glide path." TDFs are designed to provide a complete investment portfolio with an age-appropriate mix of equity and fixed income for the average investor with a retirement date in the target range.

TDFs have become an integral part of retirement plans and are estimated to represent over $1.7 trillion in investor assets … and they continue to grow.[2] One reason for this success is their simplicity as a Qualified Default Investment Alternative (QDIA). Participant-directed plans must designate a default investment, and QDIAs are deemed prudent choices that provide additional fiduciary protections under the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor (DOL), which enforces ERISA, included TDFs in its list of investments that meet the requirements to be a QDIA.[3]

Retirement Managed Accounts

Professionally managed portfolios are accounts in which an asset manager manages investments on a client's behalf, for a fee, based on the assets in the portfolio. They are ideally suited for retirement investors because the professional asset manager takes on a fiduciary role, establishes an appropriate asset allocation model based on the goals of the portfolio, and purchases, monitors, sells and rebalances a basket of securities within that model.

The main benefit of TDFs is that they are easy to use and explain. All a participant needs to know is his/her anticipated retirement date to select a TDF, but that takes engagement from individuals, and they can be overly optimistic on when they will be able to retire. Once assets are invested in a TDF, no additional action is necessary because the fund has a pre-set menu of investments that automatically rebalances according to the glide path. For plan sponsors, there are many options available from multiple providers, so the common perception is that it is easy to find a TDF series that fits the plan's needs.

TDFs are not designed to meet the actual income needs of individuals in retirement.

But being popular and easy to use comes with drawbacks. TDFs tend to have limited investment choices that are not customizable, and the formula for the glide path stays the same throughout the life of the fund regardless of market conditions. Moreover, they are not meant to target retirement income, just accumulate assets, yet they tend to become bond heavy in later years, which could impede tax-deferred objectives. In addition, TDFs are challenging to benchmark. Different studies have found tremendous variations in the returns of funds with the same retirement dates because no two TDF providers have the same investment options, asset allocation, glide path or performance.[4] This makes it difficult for plan sponsors to adequately meet fiduciary responsibilities consistent with how other plan investments are reviewed for performance and fees.

Perhaps the biggest challenge of TDFs is the single variable of retirement date. First, there is no guarantee that a person will retire in the year of the fund. Second, no two investors are alike – even ones who do retire in the same year. Each investor has different investment goals, objectives and retirement income needs. TDFs focus on accumulation and managing risk based solely on age and are not designed to meet the actual income needs of individuals in retirement. They are just designed to save and grow retirement assets using commonly accepted investment strategies regardless of market conditions.

Additionally, TDFs have not gone unnoticed by regulators. The Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) issued a "Risk Alert" in November 2019 that focused, in part, on the improper use of TDFs that should cause financial professionals to engage in additional scrutiny when implementing them in plans.[5]

The new way to retire – RMAs

RMAs present a more personalized investment option for investors and plan sponsors. Like TDFs, if properly structured, an RMA will be considered a QDIA.[6] Unlike TDFs, however, the investment account of an RMA is elected at the participant level and overseen by a professional money manager, with the goal of attaining growth within certain parameters of risk that are unique to each individual investor. Importantly, RMAs consider many variables beyond age or retirement dates, and this multiple-factor approach presents a far more personalized investment solution that better supports a participant's ability to achieve targeted retirement income goals.

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RMAs typically employ either a robo-advice service or an active money manager to develop individualized portfolios from a diversified investment menu. Data on each participant is plugged into an algorithm, which can include a participant's age, salary, gender, location, contribution rate, retirement plan balance and employer contributions. An appropriate allocation is then established based on those inputs. Over time, if inputs dictate, the algorithm will adjust the allocation to meet changing needs.

As opposed to a one-size-fits-all strategy, participants receive a personalized investment solution tailored to their needs. Since the portfolio is managed by an ERISA 3(38) investment manager with discretionary control, participants do not need to research and select investments or monitor or adjust their portfolio. They only need to keep their inputs up to date to allow the manager to properly adjust allocations.

In addition to personalizing the investment strategy, the true benefit of RMAs is that they tend to focus on replacement income rather than risk or a singular date. Creating retirement savings is not just about the accumulation of assets of a portfolio for growth, so simply investing in the "best" TDF without consideration of risk and an investment objective is not a thoughtful retirement strategy. Rather, creating a beneficial retirement investment strategy is also about managing the volatility of a portfolio based on a goal. For a properly designed RMA, that goal should be the targeted income replacement ratio, which is a formula that determines the amount of money a participant will need in retirement based on a certain percentage of his/her pre-retirement income when added to Social Security and other benefits. With such an approach, if a participant is behind goal, more risk can be taken in order to save more, and if he/she is ahead of goal, de-risking can be leveraged in order to maintain current savings levels.

RMAs thus enhance the employee experience because a goal is set that can be achieved through savings and appropriate risk taking. This is an important distinction from TDFs, which seek to reduce risk, in every occasion, as a retirement date approaches. With no specific target, if a participant is behind desired savings goals as he/she approaches retirement, reducing risk and, consequently, the opportunity for portfolio growth, would be the wrong strategy in most instances. But the design of TDFs provides no other option because the same 2030 TDF will treat two participants the same, even if one requires a 2 percent return to meet retirement needs and the other requires a 15 percent return.

Despite the benefits, RMA growth has been slow

As the chart below shows, RMAs have seen modest growth in 401(k) plans:

Managed account use in 401(k) plans[7]

Percent of plans utilizing managed accounts	2016	2017	2018
	36%	52%	59%

One reason for slower growth is that RMAs typically have fees that are higher than most TDFs. RMA fees commonly range from 30bps to 100bps, plus fees for the underlying investments. As such, many people assume that RMAs are only suitable for older investors with large balances. RMAs also require data gathering to drive beneficial returns – if insufficient data is gathered, an RMA will look like nothing more than a glorified TDF, which makes it difficult to rationalize the cost.[8] In addition, the Government Accountability Office (GAO) spooked some RMA investors when it opined that "some participants cannot be assured that they are receiving impartial managed account services or are able to rely on accountable investment professionals taking on appropriate fiduciary responsibilities."[9] And, like TDFs, RMAs are difficult to benchmark and monitor because performance is tied to individual goals.

Addressing RMA concerns

While some of the concerns are valid, RMAs can be structured to alleviate those concerns and education can help reduce reservations. Costs should certainly be considered, as participants and plan sponsors must balance the cost of a product with the potential benefits. Participants might be willing to pay a little more for a strategy that achieves their retirement income goals rather than merely limiting investment risk. A key RMA value-add is the fact that RMAs down-risk when markets are extremely strong and up-risk following a correction to sell high and buy low.

A participant's age or asset level also should not be a hindrance to investing in an RMA. If individuals are willing to put money into a 401(k) to save money for retirement at a young age, they should be willing to put that money into a strategy that gives them a better chance of achieving retirement success. There is no age or account size for which RMAs are inappropriate, and it is arguable that starting early in an RMA will better prepare participants to meet long-term needs. In addition, the participant can evaluate how increasing his/her contributions impacts the ability to achieve a retirement income, as well as how the risk of the portfolio is reduced.

Proper benchmarking is a concern, and while hard to benchmark against other RMAs, it should be understood that the proper benchmark for an RMA is how it increases the success of participants in achieving retirement income adequacy goal, as that is its target. While this is driven by performance, it is also driven by savings rate changes.

It is thus imperative … that plan fiduciaries understand all the fees related to their plan, including any subsidization as well as how the use of participant data might impact any subsidization.

The future of retirement – the ideal RMA

RMAs are more personalized and flexible than TDFs. They are also easy to use and applicable to all plan participants. Following are a few characteristics to look for in an RMA solution.

- **Liability driven investing** – RMAs should utilize the targeted retirement income approach, which is like the liability driven investment ("LDI") policies employed by most pension funds. LDI can be used for individuals too by focusing on total household income needed in retirement and the cash flow required from investments and other sources, such as Social Security benefits, to meet those needs. Once non-investment sources of income are accounted, a determination is made as to the amount of cash flow from investments needed to meet the remaining yearly withdrawals.
- **Professional asset manager** – An RMA provider should partner with a well-regarded money manager. While robo-advising is a decent gateway to an RMA offering, it tends to have more limited investment options than professional asset managers. Such a provider should be non-conflicted, with access to an extensive universe of investments from which diversified portfolios can be constructed, including low net share class investments.
- **Technology to collect participant data** – Participants in RMAs have an opportunity to customize their retirement solution. To ensure that happens, an RMA should have procedures in place to collect and apply participant data. For example, an RMA provider could use technology to automatically pull detailed data from a recordkeeping system, such as age, salary, savings rate, contributions (employee and employer), current accumulated balance, gender and location, to take the onus off participants to populate their own data set and allow even the most unengaged participant to reap the full benefit of a managed account program.

- **Personalized response to changing inputs** – Creating a personalized allocation for each participant from a broad range of investment options is an attractive alternative to TDFs which only consider age. And utilizing a target income approach gives an active manager the ability to adjust allocations in response to changing inputs. By setting up risk parameters, the manager can dial the risk up and down within guardrails to achieve the return needed to generate sufficient retirement income.

An RMA that has these characteristics, while managing the costs of the portfolio, overcomes many of the traditional concerns of managed accounts. An RMA that can provide low-cost, unbiased advice from professional money managers while utilizing automatic data collection to ensure maximum participant engagement will achieve the optimal allocation throughout a participant's life. This type of structure removes the traditional obstacle to younger or low balance participants using RMAs. Millennials, the next big generation of retirement investors, should find this attractive – they want personal engagement and personalized attention, they want to save, not "invest," and they value guidance from experienced financial professionals.[10]

1. Collinson, Rowey & Cho, What is "Retirement"? Three Generations Prepare for Older Age, 19th Annual Transamerica Retirement Survey of Workers, Transamerica Center for Retirement Studies (April 2019).

2. See, Holt, Jeff, A Brief Overview of How the Target-Date Fund Landscape is Evolving: 5 takeaways from Morningstar's latest report on target-date strategies, Morningstar Research Services (May 09, 2019), **https://www.morningstar.com/blog/2019/05/09/target-date-fund.html**.

3. See, Department of Labor, Qualified Default Investment Alternative, 29 C.F.R. § 2550.404c-5 (October 2007).

4. Wohlner, Roget, Target Date Funds Comparison – Aren't They All The Same?, InvestorJunkie, October 16, 2019, **https://investorjunkie.com/retirement/target-date-funds-comparison/**.

5. See, SEC, Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives (November 7, 2019) **www.sec.gov/ocie/announcement/risk-alert-money-market-fund-target-fund**.

6. See, 29 C.F.R. § 2550.404c-5.

7. See, Callan DC Trends Survey, 2019.

8. See, GAO-14-310 (finding that fewer than one-third of managed account participants provided personal information and noting that participants "run the risk of paying for services they are not using if they are disengaged from their retirement investments … [and] may be allocated similarly over time to those participants in target-date funds.").

9. See, GAO-14-310.

10. See, Decoding the Millennial Mindset, Broadridge and The Center for Generational Kinetics (2018).

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