MANAGED ACCOUNTS AS A RETIREMENT PLAN SOLUTION

VIRTUS INVESTMENT PARTNERS

Participants in defined contribution plans today must navigate a complicated landscape in their quest for a financially secure retirement—a landscape that looks very different than it did for prior generations. Gone is the assurance of a steady stream of income provided by a pension plan managed and funded by their employer. Gone, too, is the confidence that Social Security will remain solvent to deliver a substantial monthly paycheck and that Medicare will keep pace with rising healthcare costs.

Most workers are in charge of their own retirement destiny. Employer-sponsored defined contribution plans require employees to decide how much they should save to produce an adequate stream of income in retirement and—even more challenging—how to invest those savings. Few plan participants would consider themselves investment experts, yet they are tasked with allocating their savings across a broad menu of investment options—19-24 on average, to research and evaluate.[1]

Plan investors getting professional investment help (TDFs, managed accounts, and online advice) outperformed those without help by

3.32%

Many plan participants find it beneficial to have professional investment support to navigate the retirement savings landscape. Studies demonstrate that providing investment support can pay off. Plan participants with access to professional investment help (target date funds, managed accounts, and online advice) outperformed investors without help by 3.32% (332 basis points), net of fees.[2] In addition to a higher median annual return, participants tapping into professional investment support had lower risk and were better positioned to weather changing market conditions.[2]

Driven in part by behavioral finance concepts, the professional investment support available in defined contribution plans has evolved over time in three stages: participant self-directed investments, followed by the introduction of target date funds, and more recently expanding access to managed accounts. The lesson learned throughout this evolution is that no one strategy is best for all of a plan's participants. And, even though participants may benefit from one investment solution early in their working years, a different level of support may be needed as they near the end of their savings timeline.

Stage 1 — **PARTICIPANT SELF-DIRECTED INVESTMENTS**
Participants across all age and income demographics may prefer the flexibility of self-directed investing, with the support of investment education resources.

Stage 2 — **TARGET DATE FUNDS (TDFs)**
Younger workers and those with lower balances may find TDFs offer the investment support they need, such as diversification and automatic rebalancing.

Stage 3 — **MANAGED ACCOUNTS**
Participants with higher balances and fewer years until retirement may benefit from the higher level of personalized support a professionally managed account provides.

[1] Brightscope/Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans*, 2015, March 2018, 33.
[2] Aon Hewitt and Financial Engines, *Help in Defined Contribution Plans: 2006 through 2012,* May 2014, 5, 14-17.

ERISA Fiduciary Framework for Retirement Plan Investments

The responsibilities associated with designing a continuum of retirement plan investment solutions are set forth in the Employee Retirement Income Security Act (ERISA). Under ERISA, the named fiduciary (typically the plan sponsor) is responsible for selecting and monitoring the plan's investment options. Most defined contribution plan sponsors engage investment professionals to help select and monitor the menu of investments. Participants are then responsible for deciding how to allocate their contributions among the available investments. The plan also designates a default investment for participants who fail to make investment elections.

If the investment selected meets the qualified default investment alternative (QDIA) requirements, it is deemed to be a prudent investment, and the plan sponsor will be relieved of fiduciary liability for the default investment's performance. Offering a QDIA is not mandatory but is a popular risk management practice.

Three Investment Vehicles Qualify as a QDIA*:

– Life-cycle or TDFs

– Balanced funds

– Managed accounts

*Capital preservation products may be used as the QDIA, but only during the first 120 days of participation.

Selecting investment options with appropriate fee structures is a part of the fiduciary duty to pay only reasonable expenses from plan assets. Increasing attention has been directed to plan fees in recent years as a result of a high volume of lawsuits alleging that plan sponsors breached their fiduciary duty because they offered investments with excessive fees when lower cost options were available. Most plan sponsors rely on investment professionals to help them select and monitor default investments.

The Evolution of Retirement Investment Solutions Driven by Behavioral Finance

Stage 1 PARTICIPANT SELF-DIRECTED INVESTMENTS

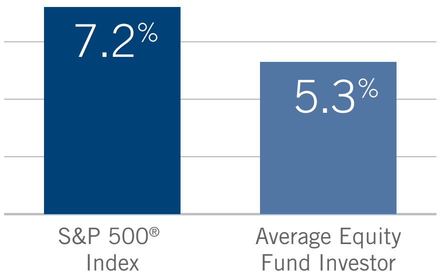
Most defined contribution retirement plans offer a selection of investment options and allow participants to choose the investments that align with their individual investment objectives and risk tolerance.

Benefits	Provides participants the flexibility to design their own portfolio from a menu of investment options prudently selected by plan sponsors; allows participants to tap into the expertise of their financial advisor, or third-party advice, if offered by the plan
Common Features	Investment education and retirement planning resources can help participants understand their risk tolerance and motivate them to take steps to build a portfolio that aligns with their investment objectives
Considerations	Behavioral finance principles reveal that participants often make poor investment decisions; a self-directed approach also requires participants to be sufficiently engaged to take affirmative steps to choose investments from the plan's menu

While retaining control over investment selection is desired by some plan participants, behavioral finance has taught us that even those individuals who have some level of market savvy and are engaged in managing their retirement plan portfolio may make poor investment choices. Investors that try and time the market have consistently underperformed by a wide margin over the past 20 years, as demonstrated by DALBAR's annual investor behavior study.[3]

Savers, left to their own instincts, will often do the wrong thing—that is, "buy high, and sell low." Others, overwhelmed by too many choices, don't act at all, failing to enroll or make investment elections. Unfortunately, investment education has not been universally effective in equipping participants to select and manage their plan investments.

20-Year Average Index vs. Investor Returns
As of 12/31/17



Source: Dalbar, *2018 QAIB Study.*
Past performance is no guarantee of future returns.

Stage 2 TARGET DATE FUNDS

To address the behavior gaps associated with participant direction, the next stage of investment strategies takes a lesson learned from automatic plan features. Plan fiduciaries may designate TDFs with "automatic features" as the default investment alternative for participants who fail to direct their investments.

Benefits	Simplifies investing for participants with limited investment experience by allocating assets to a diversified investment based on the participant's anticipated retirement date; automatic rebalancing reduces equity exposure as the participant ages, which may help manage risk and prevent poor investment choices during challenging market conditions; TDFs are easy to explain and don't require employee engagement
Common Features	Heavily weighted to equities during early saving years with the glide path becoming more conservative (fewer equities, more fixed income assets) as the target retirement date approaches
Considerations	TDFs are better suited for younger investors who have smaller amounts and a long runway to recover from market fluctuations; investors closer to retirement, who have more assets in their accounts, don't all share common investment objectives; later-stage investors also have little time to recover if the glide path experiences a setback

In addition to being a popular QDIA option, TDFs are also affirmatively chosen by a significant percentage of employees, especially younger people. One study found that while 21.3% of all 401(k) assets were invested in TDFs at the end of 2016, that number more than doubled to 47.6% among participants in their twenties.[4]

As TDF solutions have had time to take hold over the last decade, it has become clear that a piece of the investment puzzle is missing. Participants closer to retirement who have significant investments to manage may need more personalized investment support than TDFs that treat all investors of a given age the same. This is where the next stage of investment solutions—managed accounts—is being incorporated to expand the spectrum of investment support.

[3] DALBAR, Inc., *Quantitative Analysis of Investor Behavior, 2018,* www.dalbar.com. DALBAR average equity investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for each period. 20 year period ended 12/31/17.

[4] Employee Benefit Research Institute, Issue Brief No. 458, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2016," September 10, 2018.

Stage 3 MANAGED ACCOUNTS

We are now learning that as a participant's financial situation changes over time, they may achieve better investment outcomes by changing their investment strategies. As participants age and amass wealth, they have more at risk and may need more tailored investment advice based on more variables than just age. At this stage, savers need to be more precise aligning investments to their personal objectives, and have the ability to respond more dynamically as market conditions change. Managed accounts can be very effective for investors at this later stage in their savings cycle. Although managed accounts may be designated as the plan's QDIA, most plans have found managed accounts to be better suited as an option selected by engaged participants who want the support of an investment professional rather than as the plan's default.

Benefits	Participant's retirement plan portfolio is managed by an investment professional who assumes ERISA fiduciary responsibility for selecting and monitoring investments; the investment strategy is tailored to the participant's needs and objectives
Common Features	In addition to asset allocation recommendations, some providers' solutions include information or recommendations regarding the interplay of Social Security and retirement plan distributions, Roth vs. pre-tax saving options, tax-efficient distribution strategies, and projections and reports tracking progress toward savings and investing goals
Considerations	Managed accounts are not as readily available as TDFs but are being offered on an increasing number of recordkeeping platforms and through advisory firms and third-party service providers; fees for managed account services are typically paid by the participants who choose the service

As more plan sponsors and investment professionals study the impact of managed accounts, a growing number of recordkeepers are offering managed account solutions—and an increasing volume of plan assets are being moved to these investment options. When evaluated on a participant basis, 49.2% of those using professional investment support tapped into TDFs. However, when measured based on assets, managed accounts and online advice accounted for 87.7% of help usage. In that same study, managed account portfolios outperformed TDFs by 0.50% (50 basis points), net of fees (Aon Hewitt, *Help in DC Plans,* 6).[2]

Adding managed account services to a recordkeeper's platform will be increasingly important to stay competitive in this evolving market. In addition to better serving the full spectrum of participant investment needs, managed account capabilities may provide a strong appeal to advisors who provide investment support as ERISA fiduciaries. These advisors are often the gateway to recordkeeping service providers for their plan sponsor clients. In fact, some investment advisory firms are building their own managed account capabilities.

A Framework for Evaluating the Potential Benefits of Managed Accounts

Plan fiduciaries may want to consider the following factors as they evaluate whether to add managed accounts as a complementary investment solution in their plan.

Plan Demographic	Current Metric	Tips
Employee Demographics	**Age—percentage of workforce** ____ % under 25 ____ % 25–40 ____ % 41–50 ____ % 51–65 ____ % over 65 **Plan balance—percentage of participants** ____ % $10,000 or less ____ % $10,001–$50,000 ____ % $50,001–$100,000 ____ % $100,001–$250,000 ____ % $250,001–$500,000 ____ % More than $500,000	Younger workers and those with lower balances often choose TDFs as their investment solution. As participants accumulate higher balances, they are more likely to use managed accounts (Aon Hewitt, *Help in DC Plans*, 28).[2]
Current Investment Solutions	❑ Participant direction ❑ TDF ❑ Managed accounts ❑ Other: ____________	For most plans, a range of solutions may be beneficial to serve participants across the broad spectrum of ages and incomes.
Default Investment Allocations and TDFs	**Current default investment alternative** ❑ TDF ❑ Balanced fund ❑ Managed account ❑ Other: _________ **Is the default investment a QDIA?** ❑ Yes ❑ No **Percentage of assets invested in TDFs** ____ % of plan assets ____ % of participants with assets in default investment **Percentage of participants age 50 or older using TDF solutions** ____ % of plan assets ____ % participants age 50 or older	A high percentage of assets in TDFs among workers age 50 or older will help identify whether a portion of participants are at a higher level of risk during their final savings years.

Managed Account Solutions Available through Current Service Providers	❑ Advisory firm Fees $____ ❑ Recordkeeper Fees $____ ❑ Third-party service providers Fees $____ ❑ Other___________ Fees $____	In addition to evaluating the breadth and quality of services, managed account fees should be analyzed and benchmarked as part of the plan fiduciary's due diligence process. Data collected to compare solutions should include - experience (years providing managed account services) - client base (dollars and number of plans/ participants receiving managed account services) - methodology - scope of services
Employee Education and Communications Services	**Sources of investment education and communications services provided** ❑ Financial advisors ❑ Recordkeeper ❑ Third-party service provider **Types of support** ❑ Targeted communications $________ ❑ Live group training sessions $________ ❑ Individual participant meetings $________ ❑ On-demand education $________	Effective education and targeted communications campaigns can be effective in driving managed account usage

Summary

Plan sponsors have a wide variety of investment solutions to offer in today's retirement plan marketplace. Managed accounts are best positioned as a complementary option that sits beside participant-directed options and TDFs. Each option appeals to participants with different levels of expertise and potentially at a different stage of the retirement savings timeline.