PROFESSIONAL INVESTMENT ASSISTANCE REPORT

The impact of managed accounts and target date funds in defined contribution plans

2007–2016

alight

About Alight Solutions
As the leading provider of benefits administration and cloud-based HR and financial solutions, we enhance work and life through our service, technology and data. Our dedicated colleagues across 14 global centers deliver an unrivaled consumer experience for our clients and their people.

We are Alight.
Reimagining how people and organizations thrive.

Workers who used professional investment assistance earned better returns than those who did not.

A generation ago, a person could work for a company for 30 years, receive a gold watch at a retirement party, sit back and have the pension checks come in throughout retirement. While it's a happy scenario, it's one that is increasingly rare today. More and more, retirement income is in the hands of the individual worker through their investment and savings decisions.

Unfortunately, many workers feel ill-equipped to handle the challenge. Close to half of all workers we surveyed say that they are often intimidated by financial matters, and 55% feel overwhelmed by the number of different ways they can invest money.[1]

On the bright side, many employers are responding to this call for help by providing workers with access to managed accounts and target date funds. This paper discusses ways in which managed accounts and target date funds—i.e., professional investment assistance—can be effective tools for workers.

1 *Financial Mindset Study*®, Alight Solutions, 2017

This paper discusses ways in which managed accounts and target date funds can be effective tools for workers.

Availability and usage of in-plan professional investment assistance is on the rise.

- Professional investment assistance is broadly available: 93% of companies offer target date funds and 58% offer managed accounts in defined contribution plans.[2]
- Among plans that offer both managed accounts and target date funds, 12% of workers are enrolled in a managed account and 42% are full target date fund users.

Historical returns are higher on average and less volatile for workers using in-plan professional investment assistance.

- The average annualized 10-year investment return for those workers using managed accounts was 0.27% higher (net of fees) than for those workers who participated in the plan but did not use professional investment assistance.
- Over the most recent 10-year period, 25% of workers who did not use in-plan professional investment assistance had an annualized rate of return of 2% or less. Only 4% of workers who used a managed account or were at least 95% invested—i.e., fully invested—in a target date fund had an annualized 10-year return of 2% or less.

Workers using in-plan professional investment assistance have more diversified portfolios.

- Younger workers participating in plans who are not fully invested in target date funds or not using managed accounts are more likely to under-invest in equities.
- Where employer stock is offered as an in-plan investment option, workers who use in-plan professional investment assistance invest less of their balances in employer stock, thereby reducing their overall portfolio volatility.[3]

Savings decisions are better with consistent managed account usage.

- Workers using managed accounts are more likely to continuously make contributions to the plan, bolstering retirement readiness.

2 *Trends & Experience in Defined Contribution Plans*, Alight Solutions, 2017

3 We recognize that company stock represents a significant part of many companies' retirement programs. However, the risks associated with keeping a large portion of one's portfolio in any one security are well documented and material.

How effective is professional investment assistance in defined contribution plans?

Customization is everywhere you turn. Sometimes, the personalization can be small—like ordering a particular roast of coffee from the three choices of the day. Other times, the customization can be truly unique—like ordering a 200-degree, four-shot, no-foam almond milk latte. Likewise, retirement plans are increasingly adding tools and features that help workers with setting an appropriate investment portfolio. Investors who want professional investment assistance can decide to choose from a ready-made menu of target date funds or go fully customized with a managed account. However, unlike a custom coffee that can be assessed with a quick sip, it takes longer to gauge the effectiveness of these custom retirement portfolios.

The Pension Protection Act of 2006 ignited a spark that started the movement toward more professional investment assistance in defined contribution plans. Now that we have a decade's worth of returns behind us, it seems like an opportune time to look back and evaluate the effectiveness of these tools. Throughout this paper, we calculate the historical outcomes and assess the forward-looking characteristics of managed account participants to help answer some important questions:

1. **Who uses professional investment assistance?**
2. **Do people who use professional investment assistance earn better returns?**
3. **How are the investment portfolios of people who use professional investment assistance different from those who go it alone?**
4. **Are there other savings and investing behaviors that differ between those who use professional investment assistance and those who do not?**

About the report

This report is an analysis of the 10-year time period from January 1, 2007 through January 1, 2017. The data comes from nearly 50 companies which offer target date funds and managed accounts covering more than 2 million eligible participants as of January 1, 2017.

Defined contribution plan participants

Professional investment assistance: Managed account users; Full TDF users

Managed account users	Those workers who are enrolled in a managed account service at any point in time during a year. A managed account is a service wherein a participant pays a fee to a provider who selects the investment options for the participant.
Full TDF users	Those workers whose in-plan assets were at least 95% invested in one or more target date funds (TDFs) at the end of a year.
Non-users	Those workers who are neither managed account users nor full TDF users. These individuals are considered not to be using in-plan professional investment assistance.

We performed longitudinal analyses for investment performance over five- and 10-year periods and defined contribution plan participation over three- and five-year periods of time. For these topics, we compare "consistent" user types.

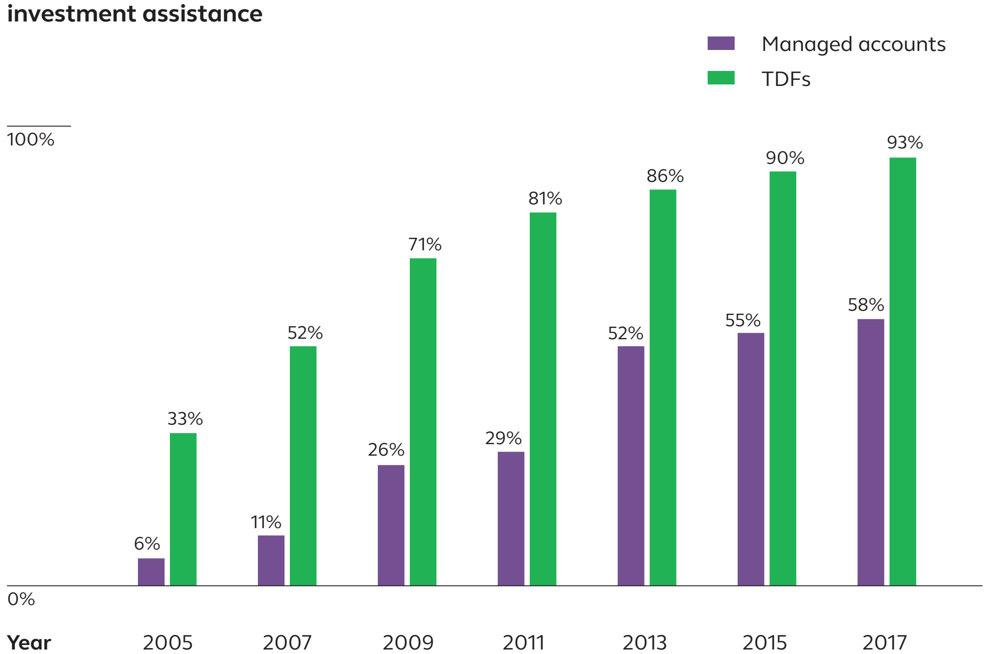
Longitudinal analyses

Consistent managed account user	Continuously enrolled in managed accounts for the entire three-, five- or 10-year period.
Consistent TDF user	Continuously enrolled in target date fund(s)
Consistent non-user	Never used a managed account or TDF
Inconsistent user	Used professional investment assistance for a portion of the time, but not for the entire time

In-plan professional investment assistance has grown over the past several years.

Just over a decade ago, few defined contribution plans offered in-plan professional investment assistance. However, there was a large jump in adoption once the Pension Protection Act of 2006 allowed companies to use managed accounts and target date funds as a Qualified Default Investment Alternative, and the prevalence has been climbing ever since. Today, nearly all plans have target date funds, and nearly six out of 10 have managed accounts.[4]

Percentage of plans offering in-plan professional investment assistance

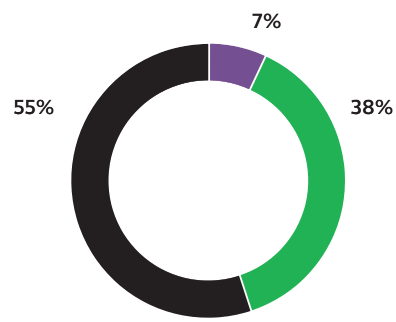


4 *Trends & Experience in Defined Contribution Plans*, Alight Solutions, 2017

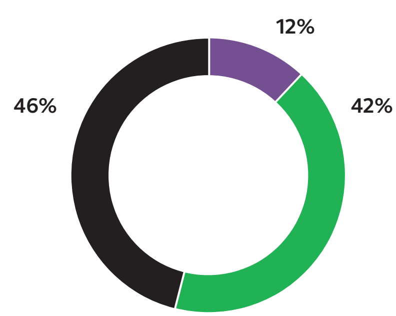
Participant use of in-plan professional investment assistance has also been climbing. Among all defined contribution plans today, 38% of users are full TDF users and 7% are managed account users. If we narrow the population to only those plans that offer both TDFs and managed accounts, the percentages grow to 42% for full TDF users and 12% for managed account users.

Participant use of in-plan professional investment assistance

Among all plans



Among plans that have both TDFs and managed accounts



Who uses professional investment assistance and how do they differ from non-users?

There are three primary demographic differences between workers who use in-plan professional investment assistance and those who do not: participant age, plan balance size, and the prevalence of automatic enrollment.

Participant demographics

	Managed account users	Full TDF users	Non-users
Average age	47.7	40.3	46.6
Average tenure	13.1	6.2	13.1
Average pay	$72,000	$56,000	$87,000
Average balance	$109,000	$30,000	$147,000

Participant age

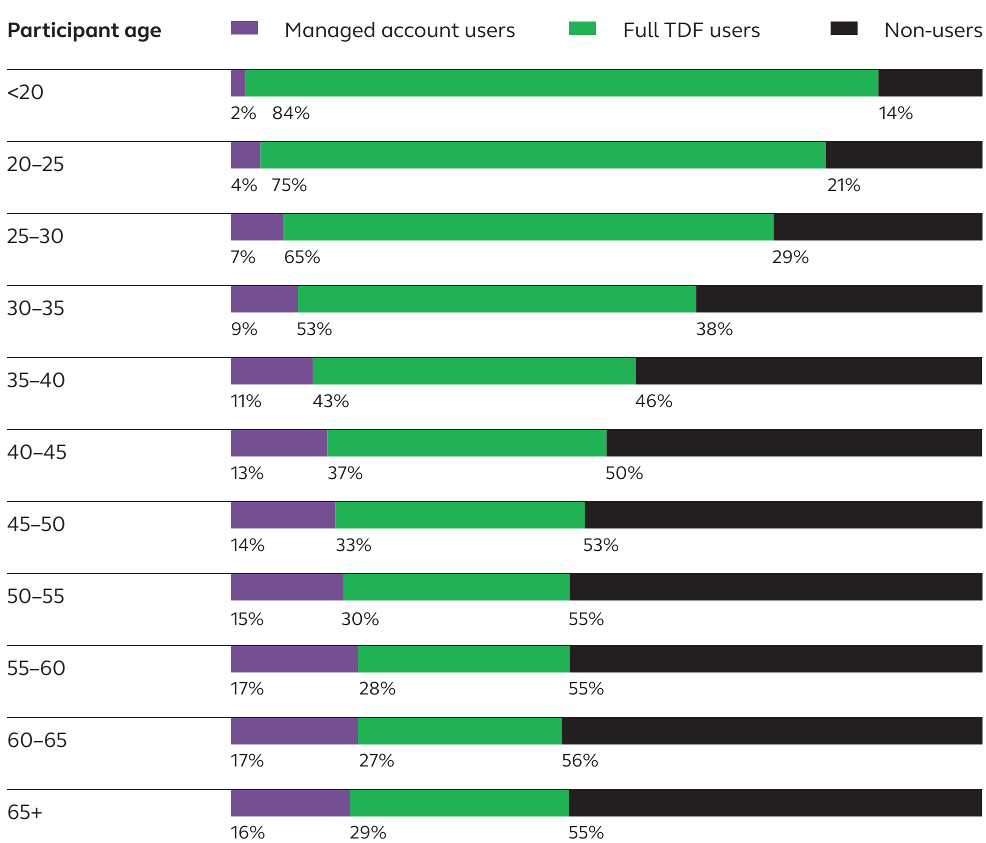
The average age of full TDF users (40.3) is more than five years younger than the average age of managed account users (47.7) and non-users (46.6). But even beyond the averages, we see that younger workers are most likely to be full TDF users. More than half of participants who are under 30 years old are full TDF users.

At the other end of the continuum, we see that older workers are more likely to be non-users. In every age cohort over age 40, the majority of workers are non-users.[5] And although the popularity of managed accounts grows as age increases, it never exceeds 20% of the participants in any age cohort.

While the growth of automatic enrollment contributes partially to this trend, age remains an important factor even when controlling for the impact of automatic enrollment. For example, among those not subject to automatic enrollment, 45% of participants under age 40 are full TDF users versus only 25% of participants who are age 40 or older.

Use of professional investment assistance[5]

By age



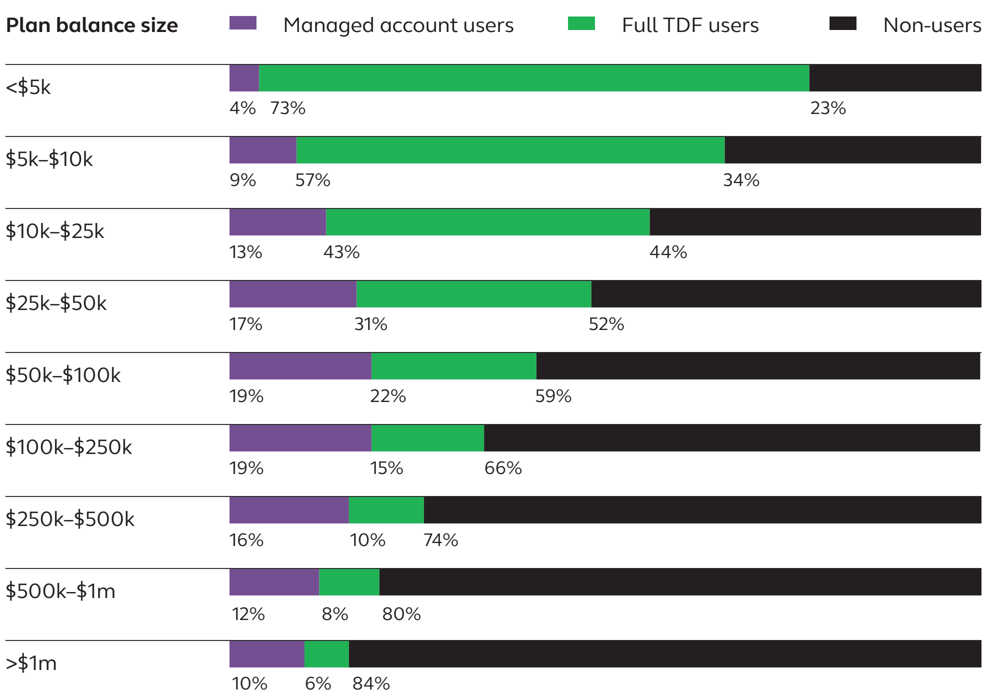
5 When managed accounts and TDFs are both available to participants.

Plan balance size

Workers with small balances are most likely to be full TDF users. However, as plan balances increase, we find that fewer participants are full TDF users. Nearly one in five (19%) workers with a balance between \$50,000 and \$250,000 is enrolled in a managed account when it is available. Usage becomes lower for participants with balances above \$250,000.

Use of professional investment assistance[6]

By balance size



6 When managed accounts and TDFs are both available to participants.

Prevalence of automatic enrollment

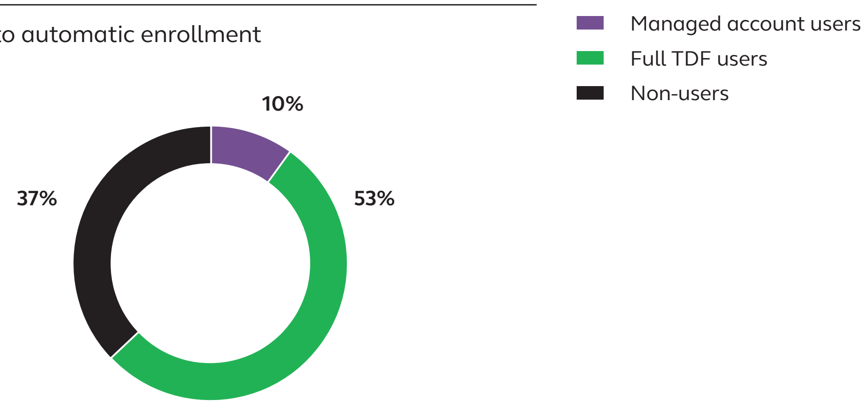
According to our *2017 Trends & Experience in Defined Contribution Plans* report, 68% of employer sponsored defined contribution plans that Alight surveyed have automatic enrollment, and the vast majority of them (83%) default workers into a target date fund. Because many participants stick with the plan defaults, it comes as no surprise that those subject to automatic enrollment are more likely to be using professional investment assistance.

Among companies offering both managed accounts and target date funds, we find that 63% of participants who were subject to automatic enrollment use professional investment assistance, whereas only 47% of participants who were not subject to automatic enrollment use professional investment assistance.

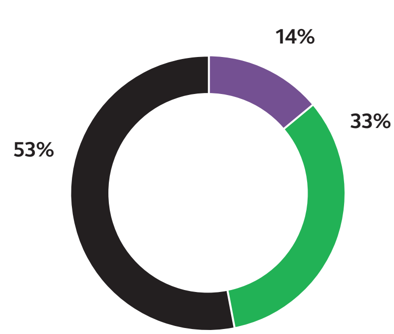
Use of professional investment assistance

By enrollment type

Subject to automatic enrollment



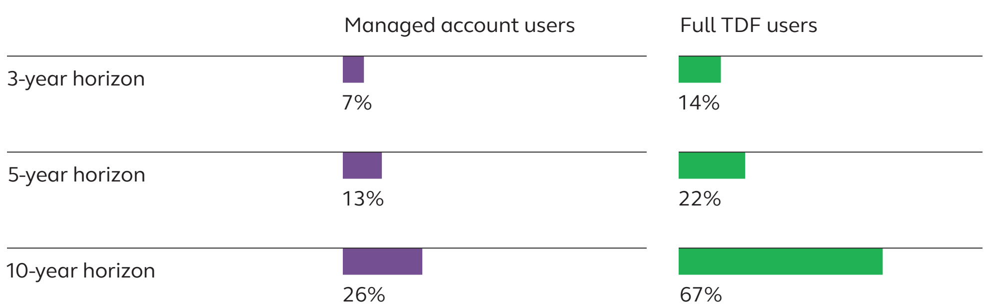
Not subject to automatic enrollment



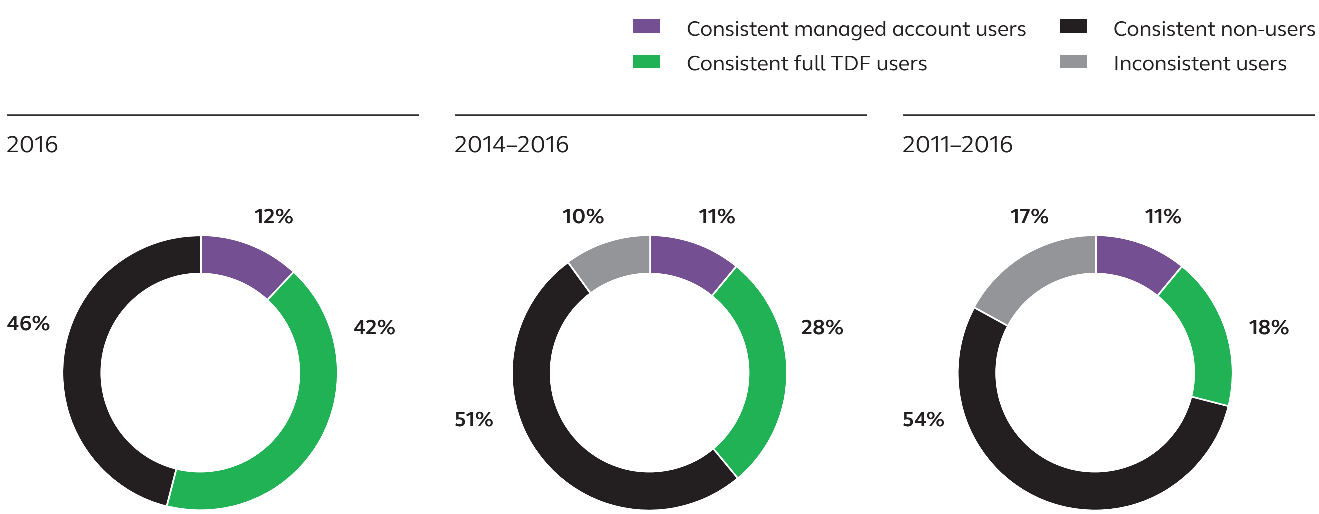
Managed accounts are “stickier” than target date funds.

Participants who use managed accounts are much more likely to stay in them than full TDF users. The rate at which workers leave managed accounts (what we define as the “lapse rate”) is lower than that of full TDF users. For example, among workers who were enrolled in a managed account during 2007 and are still active in the plan, just over a quarter (26%) exited their managed account prior to 2017. In contrast, two-thirds (67%) of fully invested TDF users in 2007 were no longer fully invested in TDFs by 2017.

Lapse rates



Use of professional investment assistance over various time horizons[7]



7 Among companies that offered both managed accounts and TDFs during the entire time horizon.

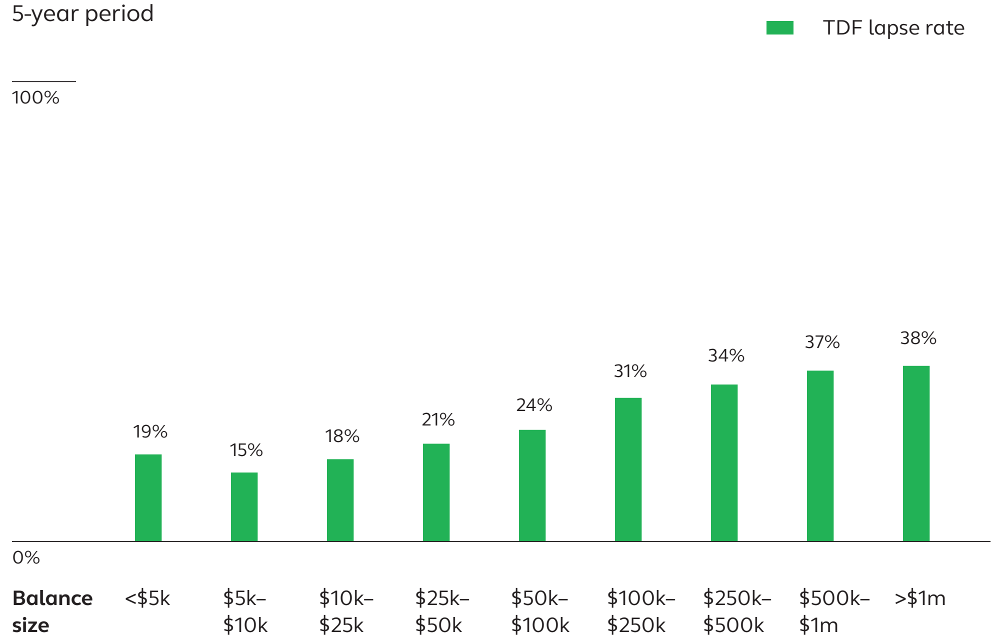
Why do participants migrate away from target date funds?

Of workers who lapse from using professional investment assistance, a majority were full TDF users. There are at least three factors that can impact this lapse rate: balance size, automatic enrollment prevalence, and risk tolerance.

Those recently hired and subject to automatic enrollment are more likely to move from a target date fund later on. Sometimes, workers decide they want to invest in a way other than how they were automatically enrolled. Within their first year, 9% of people who are auto-enrolled into target date funds end up choosing a different investment strategy.

Balance size helps inform how likely a participant is to move away from being fully invested in a target date fund. The larger the balance, the greater the likelihood of lapsing from full TDF usage.

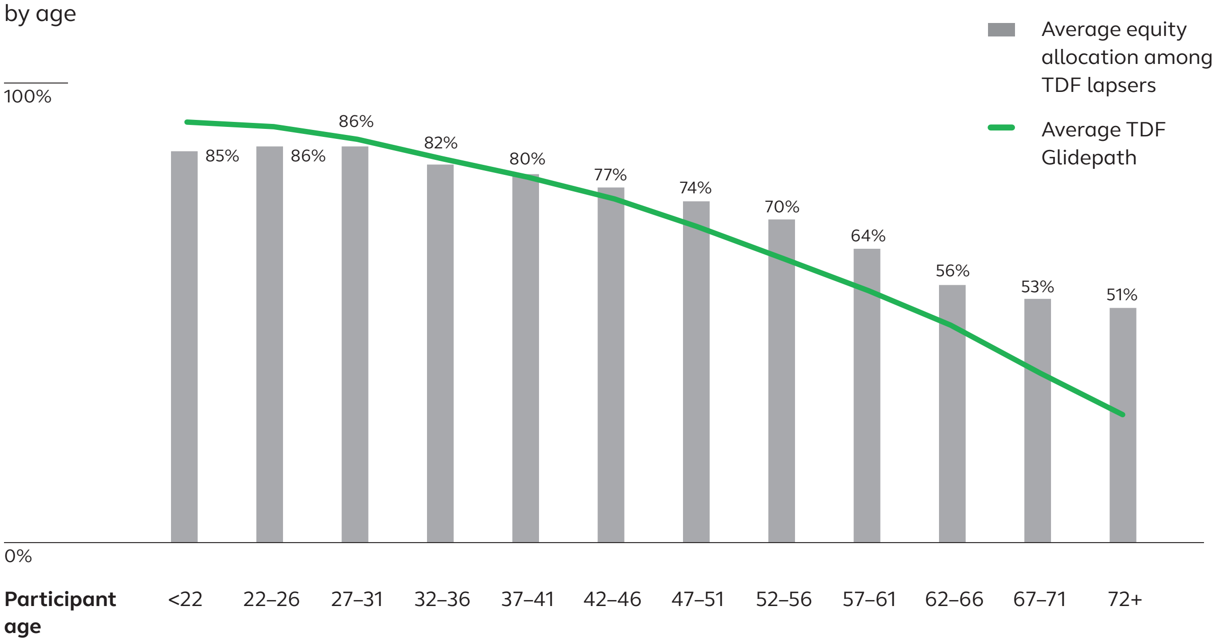
TDF lapse rate by balance size[8]
5-year period



8 Among workers who were fully invested in a target date fund on Jan. 1, 2013 and are still active in the plan.

When workers change from full TDF usage, older workers tend to increase equity concentration, while younger workers tend to decrease equity concentration. This implies that workers who choose to opt out of using the TDF as their sole investment may have different risk preferences or may be factoring in other retirement assets when setting their equity allocation. More cynically, it also could show that many participants who invest on their own may not have the acumen to appropriately diversify based on their age, risk preference, and other investments.

Average equity allocation among TDF lapsers
by age



Managed account users have had higher annualized returns over the past ten years.

Over the past 10 years, managed account users have performed better on average than full TDF users and non-users. Managed account users have earned higher average returns in five out of the last 10 years, while full TDF users have earned higher average returns in just two out of the last 10 years. In the remaining three years, non-users earned the highest average returns.[9]

Average annual return

Highlighted = Highest return

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Managed account users	**4.4%**	−31.3%	**27.5%**	13.9%	−3.8%	**13.9%**	**20.1%**	5.3%	−2.2%	**8.3%**
Full TDF users	0.4%	**−20.3%**	22.7%	14.4%	**−3.0%**	10.0%	15.1%	4.4%	−2.7%	7.4%
Non-users	−6.9%	−24.7%	25.2%	**14.5%**	−3.3%	12.5%	17.5%	**7.7%**	**−1.3%**	8.2%

Workers who consistently used professional investment assistance outperformed those who didn't. Consistent managed account users had an average annualized 10-year return net of fees that was 0.27% higher than that of consistent non-users, and consistent full TDF users had an average annualized 10-year return that was 0.26% higher than that of consistent non-users.[10]

The impact of an extra 0.25% in annual returns

April
April has contributed 12% of pay to her account each year starting at age 25. If April earns a 6% annual return, she will have a balance at age 65 that is 6% higher than if she earned a 5.75% annual return. To make up for this difference, April must contribute an additional 0.70% each year.

9 This analysis looked at annual rates of return split between managed account users, full TDF users, and non-users. "Consistent" users are those who were users for every year throughout the time period. Returns are net of fees, and annualized returns were averaged geometrically.

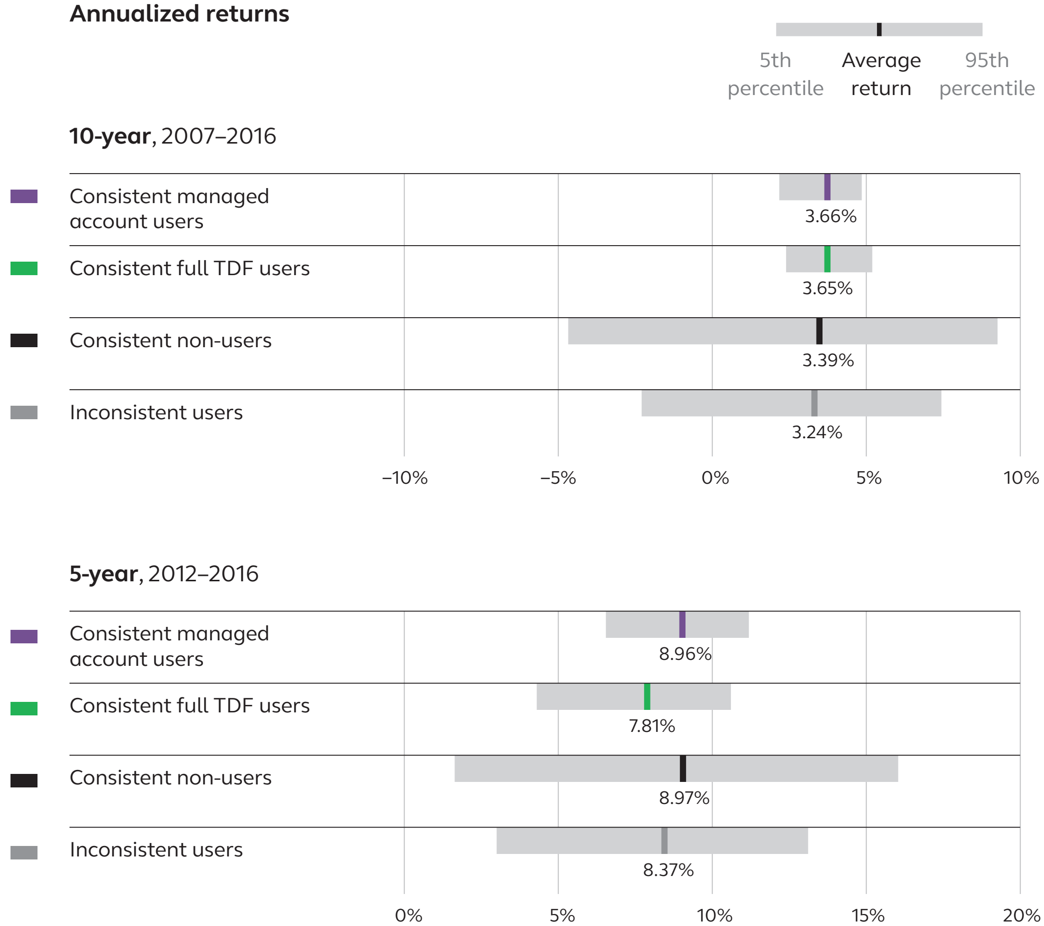
10 Among companies that have offered managed account and target date funds for at least ten years.

Annualized returns are more tightly clustered around the average for those who consistently used professional investment assistance.

Additionally, those who consistently used professional investment assistance had returns that were more tightly clustered than others. Twenty-five percent of consistent non-users earned a 10-year annualized rate of return that was 2% or less. In contrast, just 4% of consistent managed account users and 3% of consistent full TDF users earned an annualized return of 2% or less over the same 10-year period. The seventy-fifth percentile for the 10-year annualized rate of return for consistent non-users was 5.80% compared to 4.04% for consistent managed account users and 4.31% for consistent full TDF users.

However, over the past five years, target date funds have lagged. Workers who consistently used managed accounts over a five-year period earned an average annualized return that was 1.15% higher than that of the consistent target date fund users. 90% of consistent managed account users earned an annualized 10-year return between 2.10% and 4.76%, while 90% of consistent non-users earned an annualized 10-year return between –4.74% and 9.15%. Those who consistently used professional investment assistance earned a long-term return that did not diverge significantly from the average.

Annualized returns



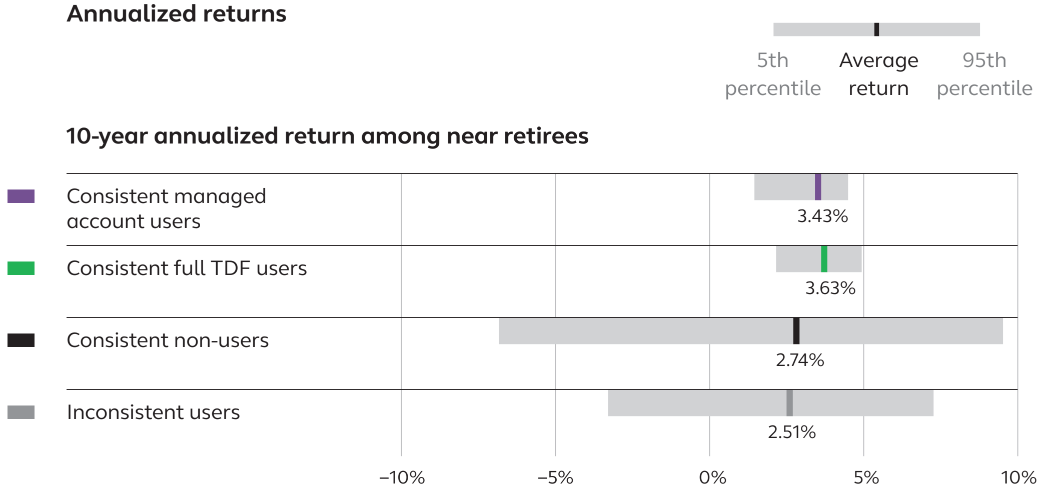
Among near-retirees,[11] professional investment assistance has been particularly beneficial. Consistent managed account users had an average annualized 10-year rate of return that was 0.69% higher than the average annualized 10-year rate return for consistent non-users (3.43% versus 2.74%), and consistent full TDF users had an average annualized 10-year rate of return that was 0.89% higher than consistent non-users (3.63% versus 2.74%).

In addition, the range of returns for consistent users of professional investment assistance was fairly narrow. Among the near-retirees, consistent non-users had an extremely wide range of returns—in fact, they had the widest range among all age cohorts in our analysis.[12]

Twenty percent of near-retirees who did not consistently use professional investment assistance earned a 10-year annualized rate of return below 0%. In contrast, just 2% of consistent managed account users and 1% of consistent full TDF users earned a negative rate of return during the same period.

Annualized returns

10-year annualized return among near retirees



11 Near-retirees are those who are currently in their 60s; i.e., they are workers who were in their 50s when the 10-year period began.

12 The standard deviation of 10-year annualized returns for consistent non-users at least age 60 was 5.15%, compared to 4.72% for those 50 to 59, 4.18% for those 40 to 49, and 3.57% for those 30 to 39.

Workers who choose to use professional investment assistance have more diversified portfolios than those who don't.

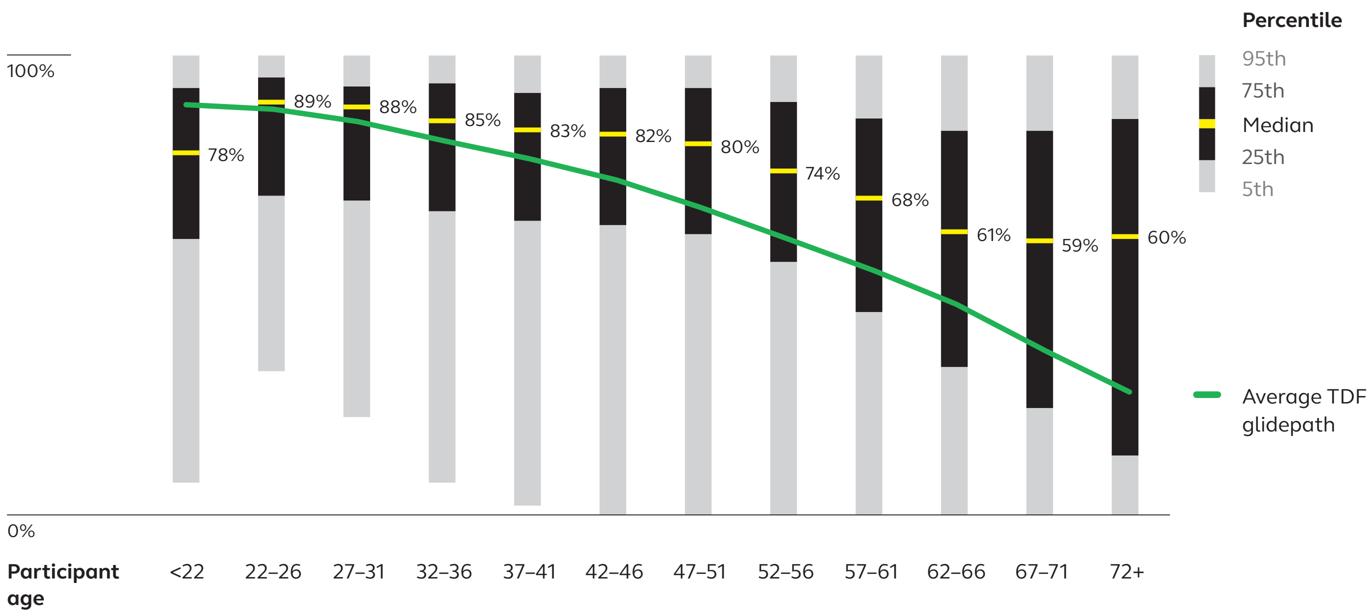
According to Alight's *2017 Financial Mindset Study®*, in a survey of more than 2,000 workers, the majority (69%) described themselves as financially savvy, yet nearly half could not correctly answer four out of five questions about basic financial concepts. Additionally, 55% of workers surveyed felt overwhelmed by the number of different ways they can invest their money. These responses indicate that there is some false confidence among workers—and a wide gap between their investment knowledge and the acumen of professional investors.

However, the verdict is in on the efficacy of managed account services and TDFs. Workers who do not use professional investment assistance tend to have poorly diversified portfolios. Some are under-invested in equities, while others are over-allocating to return-seeking investments. Additionally, workers tend to over-invest in company stock when the plan offers company stock as an investment option, increasing the volatility of future investment returns—not to mention adding that risk to their retirement income as well as their future paychecks.

When we observe the average equity allocation of non-users, we find large discrepancies compared to the average TDF or managed account. For example, among one group of 113 TDFs with a vintage year of 2045 or higher, only seven (6%) have an equity allocation less than 80%.[13] However, among non-users, 36% of those under age 35 have less than 80% of their portfolio invested in equities. Meanwhile, the average equity exposure among full TDF users at least age 55 is 54%, yet 32% of non-users at least age 55 have more than 80% equity exposure.

13 Among target date funds in the Morningstar Universe as of Dec. 31, 2017.

Equity allocation among workers not using in-plan help



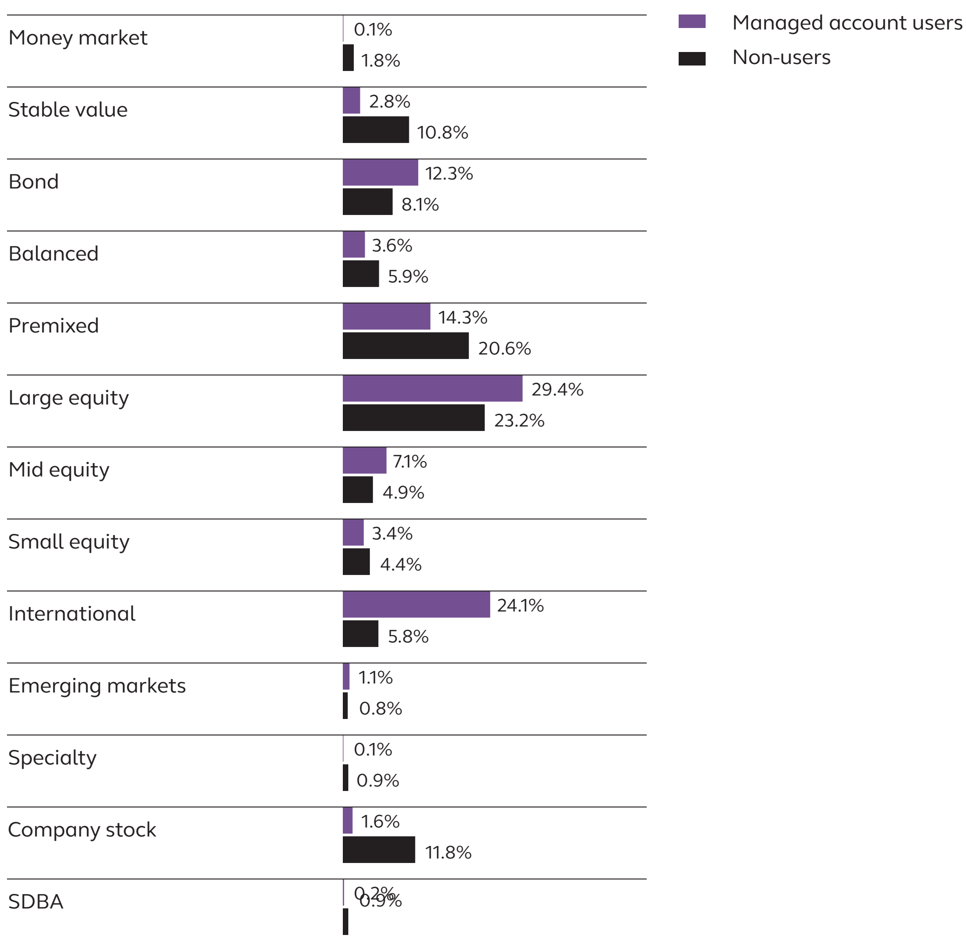
We find that managed account users have investment portfolios that are much different from those who go it alone.[14]

Non-users invest more in stable value funds and less in bond funds. Among workers over age 55, the average allocation to bonds is 20% for managed account users, compared to 10% for non-users.

Non-users invest less in international equities. The average allocation to international equities among managed account users is 24%, compared to only 6% for non-users.

Managed account users invest less in employer stock when company stock is offered as a plan investment option. Among companies that offer employer stock as an in-plan investment option, non-users invest, on average, 18% of their balance in employer stock. Managed account users have an average of 2% of their balance in employer stock.[15]

Average investment allocation
Participant-weighted average allocations for active workers among all companies.



14 Because the asset classes used within each TDF can be difficult to obtain, we limited the comparison of investment asset classes to only managed account users and non-users.

15 Among all participants with a balance greater than zero where company stock is offered.

CASE STUDY

Participant outcomes from a client with company stock

Company A's stock value declined significantly as a result of the 2008 financial crisis, and has yet to recover. As a result, many participants who were heavily invested in company stock suffered poorer returns than their counterparts who had a more balanced portfolio.

Impact of poor returns

Gary

Gary's starting balance is $100,000 and he makes total annual contributions of $5,000 between his contribution and the employer's match. Gary's balance will be $76,000 (60%) higher at the end of 10 years if he earns a 3.6% annual return rather than a −2.2% annual return.

Managed accounts reduced exposure to company stock

	Managed account users	Non-users
Percentage investing in company stock (as of Jan. 1, 2017)	7%	69%
Average 10-year annualized return	3.59%	−2.15%
Average plan balance (as of Jan. 1, 2017)	$92,600	$63,900

TDF misuse stems from a misunderstanding.

61%
say they don't know anything about target date funds

6%
of those with knowledge of TDFs gave all correct responses

As shown throughout this paper, TDFs can be an effective method of bringing professional investment assistance to workers—they are widely available and workers who are fully invested in them tend to outperform people who go it alone.

The problem with TDFs, however, is that most participants who use them do not fully invest in them. More than half of workers who use a TDF also have a portion of their balance invested in other funds.[16]

At the root of this problem is the fact that most workers do not understand TDFs. Only 11% of surveyed workers knew that TDFs are designed so they need to invest in only one fund instead of several funds.[17] When presented with five true-or-false questions about TDFs (e.g., "A TDF rebalances over time."), only 2% of surveyed workers could correctly answer all five questions. More than 60% readily admitted that they didn't know anything about TDFs.[18]

Based on your understanding, which statement(s) most accurately correspond with the intent of a target date fund (TDF)?

Target date fund		Percentage of respondents who answered correctly
Contains a mix of investment options that best reflect appropriate risk based on your anticipated retirement date	True	30%
Rebalances over time	True	13%
Designed so you only need to invest in one fund instead of several	True	11%
Investment approach tends to become more aggressive as your retirement date gets closer	False	7%
Have the same fees, asset allocation and performance	False	2%

16 "Target date funds: Who is using them and how are they being used?" Alight Solutions, 2017

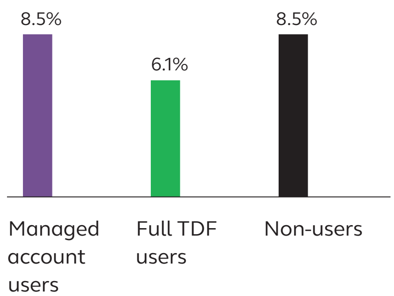
17 *Financial Mindset Study®*, Alight Solutions, 2017

18 *Financial Mindset Study®*, Alight Solutions, 2017

Workers who consistently use managed accounts more consistently make contributions to the plan.

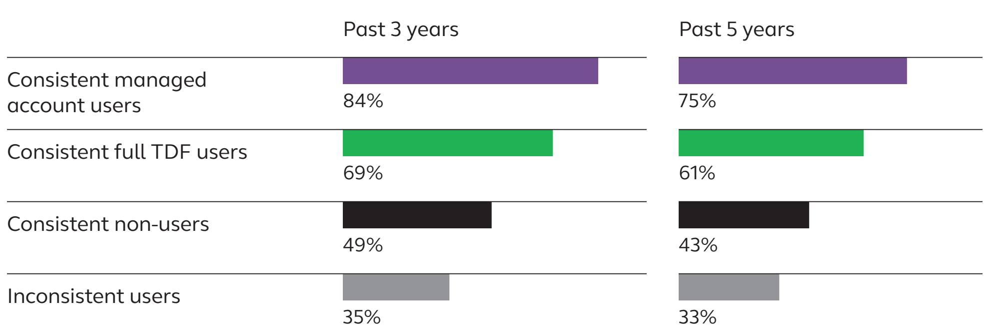
While investment returns are important to build a retirement nest egg, so too are contributions to the plan. Overall, full TDF users tend to contribute the least to their plans—a result of many using plan defaults that generally have lower average savings rates than the ones we see among actively enrolled participants.

Average contribution rate



Contributing to the plan consistently leads to more savings for participants and improves retirement readiness. Over the last three-year and five-year periods, consistent managed account users continuously participated at a much higher rate than consistent full TDF users and non-users. Three out of four (75%) consistent managed account users continuously made contributions over a five-year horizon, compared to only 43% of non-users.

Participation rate



The power of consistent contributions

Lucy, age 25
Lucy just entered the plan. When she contributes, she makes total annual contributions of 10% of pay between her contribution and the employer's match. If Lucy contributed every year, her balance could be 23% higher at age 65 than if she contributed for only four out of every five years.[19]

19 Calculations assume that contributions earn a 6% annual investment return and that contributions stop during every fifth year of employment. Pay is assumed to increase by 3% per year.

Action items for plan sponsors

In-plan professional investment assistance works. People who use managed accounts and target date funds earned higher returns than plan participants who don't use them. Furthermore, compared to non-users, workers who used managed accounts and target date funds had 10-year annualized returns that were more tightly clustered around the average. Critically, workers who use managed accounts display healthier saving and investing behaviors than their counterparts—they save more, hold lower percentages of company stock and have more appropriately diversified portfolios.

In light of this information, employers can take the following steps to help workers save for a more secure retirement:

Include professional investment advice solutions. Even though the prevalence of managed accounts has grown over the past several years, the pace of this growth has slowed. More than four in 10 employers still do not have in-plan managed accounts available to their workers.

Bolster your communications approach. Communicate more extensively about the professional investment advice solutions offered by the plan, and raise understanding of how to best utilize these tools.

Reconsider the default investment. The overwhelming majority of plans with automatic enrollment have the target date fund as the default investment option. For employers with a heterogeneous population, target date funds may not be the best choice because they cannot be easily tailored to individuals.

Embrace the next wave of innovation. The time seems right for new in-plan professional investment products that are based on more than participants' ages—as is the case with target date funds—but without some of the constraining factors that have limited the adoption of managed accounts. Keep an open mind as these products are introduced.

Have in-person seminars that explain professional investment assistance services. Employers consistently rank in-person seminars as the most effective way to spread the word about plan services. These in-person seminars can be a great way for workers to learn about different features of the plan, including managed accounts and target date funds.

Recognize that the puzzle has many pieces. Recently, employers have been expanding their financial wellness presence beyond retirement plans. Managed accounts, in particular, can be a way for workers to optimize retirement investing while factoring in other financial aspects such as a pension benefit, an account from a prior employer or a spouse's nest egg.

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