

Customize DC Investments for Participant Success

How custom investment options improve participant outcomes

July 2015

Investment advice and consulting services provided by Aon Hewitt Investment Consulting, Inc., an Aon Company.

Key Points

Choice Architecture

- Most participants in defined contribution (DC) plans are not on track to achieve retirement income adequacy. A key reason is that the investment lineups in most DC plans are structured in a way that reduces participants' likelihood of implementing well-diversified and age-appropriate investment strategies. Since they are not investment experts, most DC participants would benefit from a simplified lineup, guiding (but not forcing) them into professionally designed portfolios.
- Re-enrolling participants—sometimes called “rebooting” the investments—typically nudges a large majority of participants into the default election, often a target date fund (TDF). This helps more participants hold well-diversified, age-appropriate portfolios while still allowing the minority to opt out if they want a different portfolio.

Open Architecture

- It is increasingly feasible for plan sponsors to “customize” their target date funds, getting: a) best-in-class investment managers instead of a proprietary lineup with the same manager in every asset class; and b) more effectively diversified portfolios.
- For participants who elect out of the target date funds, plan sponsors should provide a streamlined menu of diversified objective-based funds, each of which protects against a specific risk participants face. We also believe that a passive tier that provides low-cost exposure to public markets remains appropriate. The participant who wants more choice can use a self-directed brokerage account to access mutual funds outside those designated by the plan sponsor.

Improved Governance

- Our experience is that participants generally take a favorable view of the changes described above. However, if a plan sponsor is reluctant to make such dramatic changes, a more incremental move toward simplification and customization can still provide substantial benefits for participants.
- Strong committee governance is staying the course with evolving plan design. Measuring retirement income adequacy drivers annually with a DC dashboard allows a committee to monitor whether the plan is meeting its intended objectives.

Introduction

When defined benefit (DB) pension plans ruled the retirement landscape, retirement plan assets were professionally managed by the sponsor, a type of “institutional investing.” For the last few decades, the transition from defined benefit (DB) to defined contribution (DC) as the primary retirement savings vehicle has changed participants' expectations and the solutions available to them. In many ways, the responsibility for investment decisions has shifted from professional experts to ordinary participants. This misalignment between expertise and responsibility creates a massive inefficiency.

Is there a way that DC plan sponsors can remodel DC investments to “institutionalize” DC portfolios? Is it possible to apply some of the best features of defined benefit plans to the DC environment? We believe the answer is “Yes,” on both counts.

While DC plan sponsors present many options to participants, the design and implementation of those options remain the primary drivers of a participant's investment success—and the best interests of participants is the ultimate fiduciary responsibility of any plan sponsor. In other words, sponsors and participants are in the retirement business together, even more so today than yesterday. Participants' failure to reach retirement readiness is not solely their fault. Sponsors have levers they can pull to help participants achieve retirement adequacy—by embracing several choice and open architecture solutions, as well as improved governance processes for plan management.

- **More than 55%¹ of sponsors lack confidence** in participants' ability to self-manage retirement readiness.
- That lack of confidence is warranted. **Current savings levels** (7.6%²) for the average participant are **not enough** to achieve retirement income adequacy.
- Professional help has been demonstrated to improve portfolio returns. The median annual return for **participants using help was 3.32%³ higher than that of those who did not.**

The most fundamental principle of retirement investing is the time value of money. The core belief is that money saved today can grow through investments. Through plan design, sponsors can influence the two most important resources—time and money saved—by using automatic features such as auto-enrollment and auto-escalation. The third component of potential earning capacity is the investments in the plan, which plan sponsors can influence by providing simple choices that facilitate good decision making by average participants who are not investment experts.

Bringing this full circle, institutional investment management implemented within DB plans is a professionally built, multi-asset class solution that achieves an efficient risk-adjusted return with an optimal fee structure. Bringing the same type of institutional management to DC plans enables the professional help participants need to achieve their retirement income objectives. The additional value to DC plans includes:

- **Manager flexibility.** Using a multi-manager approach allows sponsors to choose “best-in-class” managers for every asset class and replace them with limited participant disruption.
- **Enhanced investment options.** Customized, multi-asset options allow for sleeves of diversifying assets such as real assets, private real estate, and possibly even hedge funds.
- **Fee advantages.** There is potential for an optimal fee structure by achieving institutional pricing through plan size, consolidating options, and efficiently blending active and passive strategies.

Using Participant Data to See the Problems: Do We See the Participant Through the Forest?

The critical question at hand for plan sponsors is, “*How do participants benefit from our proposed solutions?*” We can find the answer by examining data about participant behavior. You may have heard the phrase about “missing the forest through the trees.” The reverse can also be true: missing the trees through the forest. Applying this to DC plans, **sponsors that look only at high-level plan averages may not fully understand the varied experiences of the underlying individual participants.**

¹ Aon Hewitt. 2014 Hot Topics in Retirement

² Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

³ Financial Engines and Aon Hewitt's 2014 Help in Defined Contribution Plans: 2006 through 2012

Plan sponsors should first consider trends in participant behavior, and then account for those motivations when developing a holistic investment menu. Customization results in more relevant and efficient options on a participant-by-participant basis, which in turn contributes to greater success at the total plan level.

Let's start by breaking down the plan participants into two types of individuals. All plans have different types of investors, ranging across a spectrum from "Delegate" to "Empower Me."

1. **"Delegate"** investors want helpful guidance and are best suited for a pre-mixed option like a target date fund or other professionally managed solution.
2. **"Empower Me"** participants are more active and want freedom of choice.

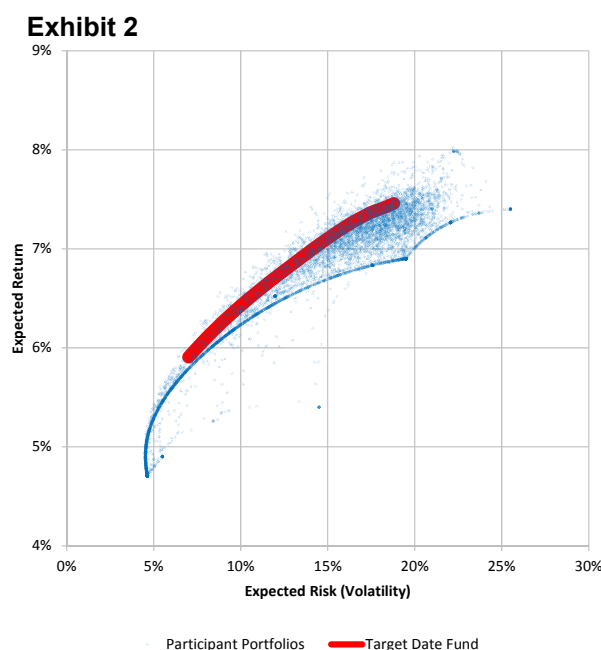
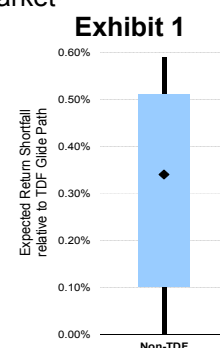
In 2014, "Delegate" investors represented 37%⁴ of plan participants, and the remaining 63% tested their skill within the "Empower Me" group. Though participants are educated as long-term investors, a study shows that regardless of a fund's label, the retention rates for an equity or fixed income fund average about three to five years⁵. "Empower Me" participants are not staying the course through full market cycles and are struggling with several key decision-making biases:

1. Inappropriate risk taking
2. Suboptimal diversification
3. Market timing

Inappropriate risk taking: Participants often do not take the most appropriate level of risk for their time horizons. We found that approximately 60%⁶ of participants who do not seek professional help had inappropriate risk levels. Approximately two-thirds of those were taking on too much risk—such as a 65-year-old with 100% equity. Approximately one-third were taking on too little risk—such as a 25-year-old with 100% cash.

Suboptimal diversification: We analyzed participants by comparing each participant's allocation to a well-diversified portfolio based on an "efficient frontier" calculation to see if participants were maximizing their returns for the level of risk. Those who took an "Empower Me" approach, on average, had significantly less diversified portfolios than those using the professionally designed target date fund. This case study (illustrated within Exhibit 1⁷) shows that suboptimal diversification costs 30 basis points in annual performance for more than 50% of participants. Carried over a participant's career, an annual return shortfall of 30 basis points amounts to 0.8 times⁸ final pay—a substantial sum.

To see these suboptimal allocations (Exhibit 2⁹), each blue dot represents a participant's allocation versus the target date fund (TDF) glide path, which is the red line.



⁴ Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

⁵ 2013 QAIB Quantitative Analysis of Investor Behavior

⁶ Aon Hewitt and Financial Engines: Help in Defined Contribution Plans: 2006 through 2012

⁷ Aon Hewitt Investment Consulting

⁸ Assumptions: 12% contribution, \$50,000 starting wage at age 25, 3% COLA, 7% index return, 6.7% investor return, retirement age is 65

⁹ Aon Hewitt Investment Consulting

When only non-TDF assets are considered, participant portfolios are generally less efficient than the TDF glide path.

Outside target date funds, the majority of assets are invested in U.S. equities and U.S. core fixed income funds. These are visible (Exhibit 2) as the outlined “minimal frontier” below the mass of participant portfolio outcomes. This level of home country bias builds the case for objective-based funds that are constructed with a more diversified investment composition to aid participants in building their own asset allocations.

Market timing: Participants who switch among asset classes in an attempt to profit from the changes in their market outlook are considered to be timing the market. Studies have shown that segments of “Empower Me” participants unsuccessfully attempt this type of market timing. Our research shows that 19%¹⁰ of participants who build their own asset allocation made a trade in 2014. That number was higher in 2008 during times of great market volatility. Studies also show¹¹ that participants tend to track the market much more closely in bull markets, such as during the last six years, and big lags occur during bear and volatile markets. It is during these periods that participants’ guesses about market peaks and troughs truly impact their long-term returns. This is an example of the importance for sponsors of looking beyond the plan averages. For the portion of participants who engage in this behavior, the compounding effect may destroy about 2% of their returns annually—or 4.1 times final pay¹² when compared to the market over the past 10 years, as shown by Morningstar¹³ and DALBAR¹⁴ studies.

Action 1: Re-enrollment Is the Optimization Button

The most effective way sponsors can improve participants’ suboptimal diversification and inappropriate risk taking is through re-enrollment, sometimes called “rebooting the plan.” In a re-enrollment scenario, all participants are required to update their elections or be moved into the default elections—usually the target date fund. Some “Empower Me” participants may eventually change back to building their own asset allocations, but most will likely stay in the default election. Re-enrolling all participants into a target date fund improves most participants’ investment programs through increased diversification and more age-appropriate risk levels; this ultimately leads to better retirement outcomes. Aon Hewitt believes the safe harbor protections through provisions of the Pension Protection Act of 2006 (PPA) make re-enrollment one of the most effective tools within the sponsor’s kit.

Re-enrolling all the plan assets into the plan’s target date fund presents an excellent opportunity to reexamine the target date funds in light of participants’ needs.

Action 2: Benefits of Custom Target Date Funds

Most target date funds are designed around the business model, capabilities, and views of a single investment manager and an average DC population. This often diverges from a best-in-class diversified portfolio built to suit a specific plan’s population. For example, many target date funds use all active management in every asset class *with the same investment manager*—a practice that is almost unheard of among sophisticated DB plans. Further, it is not uncommon for investment managers with strong reputations in a particular asset class to have above-average allocations to that asset class in their target date funds. Usually we like investment managers to focus on their strengths; in this case, however, we

¹⁰ Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

¹¹ 2013 QAIB Quantitative Analysis of Investor Behavior

¹² Assumptions: 12% contribution, starting at age 25, 3% salary increases, 7% index return, 5% investor return, retirement age is 65

¹³ Russell Kinnel. 2014. *Mind the Gap*

¹⁴ 2013 QAIB Quantitative Analysis of Investor Behavior

posit that managers may be selecting asset allocations that are suboptimal from the participant's perspective in order to favor their engine for active management.

One solution to these issues is passive management. Though we like many things about passive management, it has downsides too, especially within target date funds. Specifically, many passive target date funds are less diversified than their active competitors, often having less exposure to asset classes like real estate, high yield bonds, emerging market debt, and real assets. Further, DC plan sponsors that also offer DB plans may think it is important to leverage consistency in the active vs. passive management treatments between their target date funds and other asset pools. But are sponsors acting in the best interests of participants if they are using a different approach with participants' money?

On top of all this, a traditional off-the-shelf target date fund is not designed around a plan's population. Participants may have different expected lifetimes, average retirement ages, DB plan benefits (even if the accruals are frozen), contribution patterns, or risk tolerances. All of these could influence the desired glide path for a target date fund. One solution to the issues presented by off-the-shelf target date funds is to use "custom" target date funds.

Custom TDFs are fully open-architecture TDFs in which plan sponsors select the asset classes to include, the funds to use, and the glide path that governs how those asset classes and funds will evolve over time. Plan sponsors are able to monitor and adjust these custom TDF elements just as they do for the other aspects of their defined contribution plan investment structures. The plan sponsor explicitly retains control over decisions regarding more aspects of the TDF, and thus is better able to control the risk exposure for its participants. The additional decisions imply that custom TDFs require more ongoing oversight. While this approach was cutting-edge several years ago, today it is increasingly common and more accessible to a growing array of plan sponsors.

Further, the Department of Labor provided fiduciary guidance on custom TDFs with its 2013 publication, "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries,"¹⁵ which told plan sponsors:

"Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan. Some TDF vendors may offer a pre-packaged product which uses only the vendor's proprietary funds as the TDF component investments. Alternatively, a "custom" TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF. Nonproprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider. There are some costs and administrative tasks involved in creating a custom or nonproprietary TDF, and they may not be right for every plan, but you should ask your investment provider whether it offers them."

Building a custom TDF begins with designing a solution that is in the best interest of participants, which is the ultimate fiduciary responsibility. A custom TDF allows sponsors the ability to address their plan's unique participant needs, using an institutional approach to portfolio management that blends best-in-class active managers with low-fee passive managers, diversified asset classes, and a risk level that is designed for the plan participants. This is accomplished by tailoring the strategic glide path, applying innovations in portfolio construction, and best-in-class manager selection and due diligence.

¹⁵ <https://www.dol.gov/ebsa/pdf/fsTDF.pdf>

Action 3: Streamlined Core Lineup of Objective-Based Funds

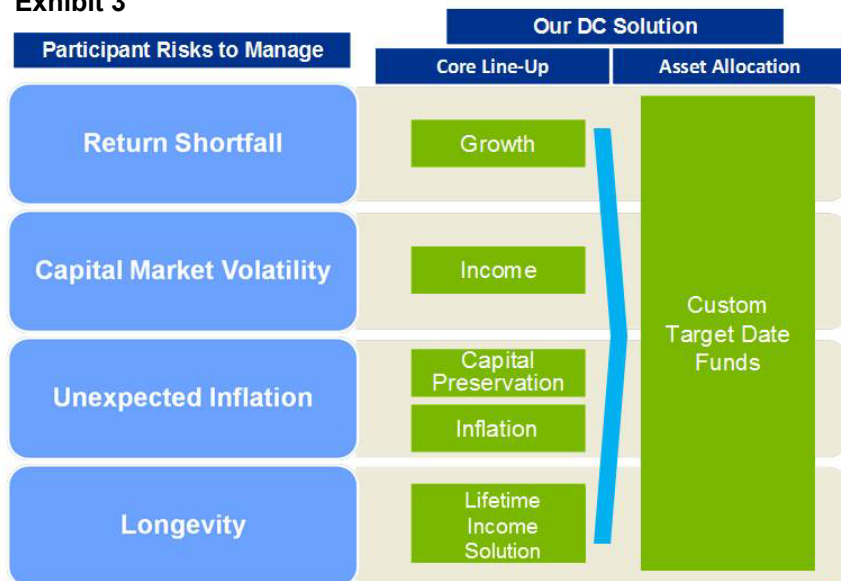
TDFs are not for everyone. Therefore, it is beneficial to build the core lineup on the same tenets and investment principles as the custom target date funds. Consistency in investment philosophy and construction provides participants with better resources, and sponsors with more efficient governance. Can the core funds take a page from the diversification and communication benefits of target date funds? The answer is “Yes,” provided that they are combined to clearly highlight and define their investment objectives.

Today’s most common DC investment lineups confuse participants with 18 to 25 asset-style funds, most of which are named with technical investment jargon, making it difficult for most participants to effectively build portfolios. It is not surprising that plan data shows¹⁶ participants using today’s investment lineups have poorly diversified asset allocations. Too much choice doesn’t result in improved diversification for participants. The DC lineup of the future will mitigate this problem by replacing today’s core options with the optionality of a simple passive tier and a custom multi-asset class objective-based tier that are professionally managed to improve outcomes. These improvements to participants’ asset allocations are critically important to retirement outcomes, as asset allocation drives roughly 94% of investment returns¹⁷.

Succinctly stated, **objective-based funds are multi-asset class funds that are designed to meet specific investment objectives**. As shown in Exhibit 3, we believe that a DC investment lineup can include as few as four options to span the broad array of objectives for the vast majority of participants. These objective-based funds are:

1. **Growth.** Generating capital appreciation (equities and higher-octane assets)
2. **Income.** Producing returns through dividends and interest payments (predominantly high-quality fixed income)
3. **Capital preservation.** Preventing investment loss (stable value or money market)
4. **Inflation.** The investment maintains purchasing power against inflationary shocks (TIPS, real estate, and other inflation-linked assets)¹⁸

Exhibit 3



¹⁶ Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

¹⁷ Roger G. Ibbotson. “The Importance of Asset Allocation,” *Financial Analysts Journal* Volume 66 Number 2 ©2010 CFA Institute

¹⁸ A fifth objective for participants is longevity—to protect against outliving the assets. This is usually addressed through a combination of the four core investment options listed, well-paced spending patterns, and insurance products. Aon Hewitt October 2014: Longevity Insurance in DC Plans—Paving the Way for QLACs

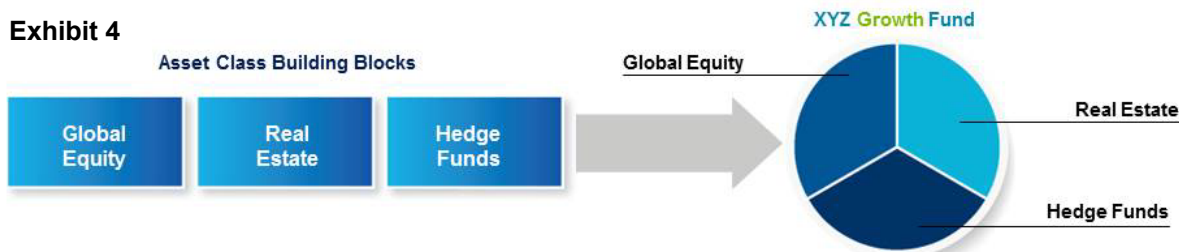
Unfortunately, today's traditional investment lineup makes it difficult for participants to have line of sight into how the funds translate into objectives. Even the participant who has the investment savvy to understand the relationship between the objectives listed above and the funds' asset styles must still determine the right mix of funds to best meet the objective. Take, for example, the more knowledgeable participants who see that both a large cap index fund and an international equity fund are designed to meet the "growth" objective. They must still determine how much to allocate to each fund to best meet the overall growth objective. Additionally, they must see if there are other funds in the lineup that also meet the growth objective. If so, the allocation process starts anew.

Objective-based funds are designed to remove these friction points. Plans with objective-based funds make participant success more likely by offering a streamlined menu with each of the investment options offering a specific objective. What's more, objective-based funds allow for new investments that plan sponsors might not offer in a traditional asset-based lineup.

Consider the growth fund, a fully diversified return-seeking option guarding against return shortfall. The diversification is derived from the fund's ability to access global equity as well as diversifying growth assets such as core real estate, return-seeking fixed income, real assets, or possibly even hedge funds, which might not normally be available to participants through a standard core menu lineup. Implemented the same way as custom TDFs by blending best-in-class active managers with low-fee passive managers, implementing an objective-based fund lineup adds value by keeping the participant interface simple while employing a professionally designed portfolio construction underneath. This is accomplished via more effective participant communications, sophisticated diversification, and optimal pricing. All three are important factors for encouraging participants to build more efficient asset allocations.

Menu Simplification Improves Decision Making

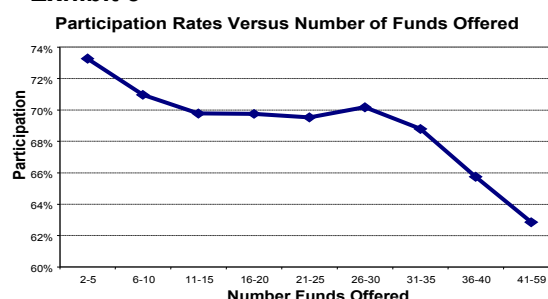
Return chasing and loss avoidance are reducible behavioral risks. Exhibit 4 illustrates that reducing three asset classes into a single diversified objective-based growth fund is straightforward. With limited options,



there is less "grass is greener" temptation for participants to switch funds. Offering too many choices facilitates a situation in which participants chase "green" lights while running from "red" lights when reviewing their accounts online, and fuels buy-high and sell-low behaviors.

Behavioral finance research demonstrates that too much choice within DC plans harms participant decision making. On average, participants select only 3.6¹⁹ investment

Exhibit 5



¹⁹ Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

options. This selection concentration is a primary reason why sponsors should limit the plan to a small number of efficient options.

In Exhibit 5, we start to see a 3%–4%²⁰ dip in participation when fund menus have six or more investment options. Today, this experience is still the case for those plans not using automation post-PPA 2006. We also see history repeating itself with health savings accounts that have oversized investment lineups. Providing a reasonable number of investment options helps participants invest more over long periods of time.

Action 4: Self-Directed Brokerage Fund Window

There will likely be a very small proportion of participants who are dissatisfied with streamlined choices. Plan sponsors could provide a self-directed brokerage fund window for these participants so they can choose their own mutual funds (not vetted by the plan sponsor). Although only about 4%²¹ of participants typically use this option when it is available, it can be effective at reducing concerns among a vocal minority.

White Labeling Is Becoming Commonplace

Custom target date funds and objective-based funds are forms of “white-label” funds, which are generically named funds that have no association with a fund company and are branded by their asset class, strategy, or objective. They can be constructed as either a single investment strategy or as a portfolio of multiple underlying investment vehicles structured to the fund’s objective and related to any asset class, asset style, market capitalization, or geographic region.²²

Technology advancements have made it easier to incorporate white-label funds within plans. White-label funds can be organized in different ways to satisfy plan sponsors’ goals and participants’ needs. The components of these funds are the building blocks for custom investment solutions, often created by utilizing a plan’s existing investment options and supplementing them as needed with other offerings to complete the portfolios the sponsor is trying to construct.

Based on Aon’s *2014 Retirement Pulse* survey of plan sponsors, almost 25% of plans currently offer some level of white-label funds. White labeling investment options is the foundational starting point for custom investment solutions. It allows sponsors the structural framework to label plan investment options with a more basic, user-friendly name such as “Inflation” or “Growth” fund, instead of “the XYZ Asset Management Fund.” The reasons sponsors are making the change to these structures include²³:

- 71% to combine multiple managers
- 64% ease of changing managers
- 57% ease of participant communications
- 43% lower total fund fees

²⁰ Iyengar, S.S., and W. Jiang. 2005. “The Psychological Costs of Ever Increasing Choice: A Fallback to the Sure Bet.” *Journal of Personality and Social Psychology*

²¹ Aon Hewitt. 2015 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans

²² Aon Hewitt. October 2014: “What’s in a Name? White-Label Funds in DC Plans”

²³ Aon Hewitt’s 2014 Retirement Pulse Survey

In some sense, white labeling is already a practice adopted by all sponsors who currently offer a TDF, since TDFs are diversified multi-asset class structures with intuitive names like “XYZ 2025 TDF.” If you believe in TDFs, then in concept you already believe in white-label funds. For more details on the implementation of white-label funds, please see our paper, “What’s in a Name? White-Label Funds in DC Plans.”²⁴

What Is the Impact of Fees?

We have already looked at misguided risk taking, suboptimal allocations, and market timing impacts on participant outcomes. Additionally, maintaining reasonable fees can also impact participant outcomes.

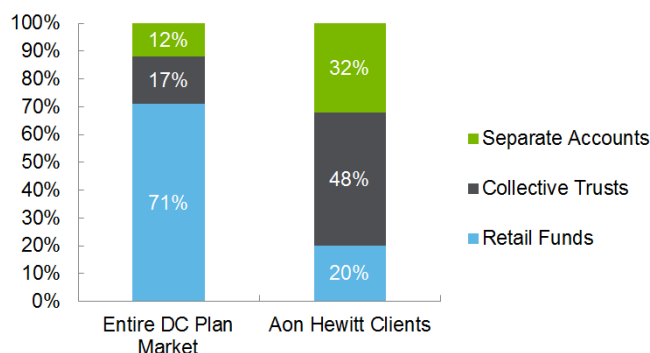
One benefit of sponsored DC plans is the ability to leverage the amount of the combined employee base’s assets to access institutionally priced fund structures. The benefits of size are even stronger in our proposed investment structure. Here, the same managers are used for the core lineup and custom target date funds; further, with fewer options, the assets would likely be concentrated with fewer managers. In addition, the white-labeled multi-asset structure we propose allows plan sponsors to blend active and passive management together, helping to control costs and take active risks where they are most likely to be rewarded.

Simply considering the mutual funds that are available to most DC plans, asset levels give sponsors the opportunity to move from retail-priced funds to institutionally priced funds. Across the entire DC market (Exhibit 6), 71%²⁵ of the share classes utilized are retail-priced. A retail-priced fund has the same cost structure a participant could access via a self-directed IRA.

We looked at Morningstar data to calculate the difference between the average retail fee²⁶ and the average institutional²⁷ share class fee. The average differential is 67 basis points for large cap equity and 59 basis points for core fixed income. For some plans, the annual savings from transitioning from retail to institutional shares may be as high as 65 basis points for participants within the 71% shown in Exhibit 6. Through plan governance, a sponsor’s ability to decrease fees by leveraging consolidated plan assets via a smaller lineup can increase participants’ age 65 balances by roughly \$250,000²⁸ or 1.6 times final pay. If those plans already using institutional share classes allow for the use of collective investment trust and/or separately managed account vehicle structures, the reduction in fees from consolidating assets is generally smaller—but still likely meaningful.

Exhibit 6

Utilization by Vehicle Type



²⁴ Aon Hewitt. October 2014: “What’s in a Name? White-Label Funds in DC Plans”

²⁵ Aon Hewitt, ICI, and Cerulli

²⁶ Retail universe is constructed using investment metrics peer group parameters, Morningstar annual report expense ratios with no minimum initial purchase constraints, and the maximum fee per unique strategy where multiple share classes exist

²⁷ Institutional mutual fund universe is constructed using investment metrics peer group parameters, Morningstar annual report expense ratios with up to a \$1 million minimum initial purchase constraint, and the minimum fee per unique strategy where multiple share classes exist

²⁸ Assumptions: 12% contribution, \$50,000 starting wage at age 25, 3% COLA, 7% index return, 6.35% investor return, retirement age is 65

The Path Forward

Some of the proposals in this paper are meaningfully different from the track many plan sponsors are on today. Those that have already moved in this direction, however, have generally received favorable responses from participants. While this paper represents the DC lineup of the future, we also acknowledge that not all plan sponsors are prepared to implement all of these proposals immediately. Nevertheless, there are substantial benefits to a gradual implementation that moves toward simplicity and customization.

As shown in Exhibit 7, this might mean implementing only a custom target date fund or reducing the core lineup to have fewer, more thoughtful options. Progress can be made in many ways—perhaps it is white labeling within an asset class structure or changing the lineup without re-enrolling. Exhibit 8 below shows some intermediate positions between the typical and future investment structure.

Exhibit 7

Aon Hewitt's best thinking in defined contribution investment line-up design

Delegate	Empower Me		Enable Me
CUSTOM TARGET DATE MENU	PASSIVE TIER	OBJECTIVES BASED	SELF DIRECTED BROKERAGE
Retirement Income Solution Fund	Equity	Growth	
2015 Retirement Solution	Fixed Income	Income	
2020 Retirement Solution		Capital Preservation	
2025 Retirement Solution		Inflation	
2030 Retirement Solution			
2035 Retirement Solution			
2040 Retirement Solution			
2045 Retirement Solution			
2050 Retirement Solution			
2055 Retirement Solution			
2060 Retirement Solution			

Hypothetical DC Investment Line-Up Solution

Exhibit 8

CURRENT	BETTER	BEST PRACTICE
No automation	Semi-automation	Fully Automated
Participant Driven	Plan Sponsor auto-enrolls new participants and has a one-time re-enrollment of existing participants into the plan's a QDIA	Plan Sponsor auto-enrolls new participants, auto-escalates existing participants annually and automatically re-enrolls all participants every few years into the plan's QDIA
Target-Date Funds		
Off-the-Shelf TDF	Custom TDF	Enhanced Custom TDF
Proprietary Single Provider	Constructed from funds available only on the Core Lineup	Include diversifying assets not in core lineup
Choice-based Lineup¹	Asset-class Lineup	Objective-based lineup
Large Cap Value Large Cap Index Large Cap Growth	Large Cap	Growth
Small/Mid Cap Value Small/Mid Cap Core Small/Mid Cap Growth	Small & Mid Cap	
Non-US Value Non-US Index Non-US Growth	Non-US Equity	
High-Yield Bonds Global REIT Other Specialty Funds	Hybrid Equity	
Core Bond Core Bond Index Private Real Estate	Core Bond	Income
Stable Value/Money Mkt	Capital Preservation	Capital Preservation
TIPS Commodities	Inflation	Inflation

¹Choices are shown for illustration and sometimes may not be used as standalone option(s)

Retirement Income Adequacy

The overarching role of the committee and sponsor is governing a plan in the best interests of its participants. When evolving the plan through customization, it's important to measure and monitor the impact of the plan's changes on its participants. We believe a committee and sponsor should implement a DC dashboard to monitor the various drivers of participants' retirement income adequacy—at least annually.

Defining Income Adequacy

We analyze retirement income adequacy based on the surplus or shortfall of retirement resources versus retirement needs. If retirement resources exceed retirement needs, then the individual can anticipate a retirement income surplus through an average postretirement lifetime. Conversely, if resources are not sufficient to cover needs, then the individual can anticipate a shortfall, and may need to consider either taking action to increase retirement resources prior to retiring, or reducing retirement needs.

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Measuring Retirement Income Adequacy

Through the Aon *Real Deal* study, we express each employee's retirement needs and resources as a multiple (e.g., 15.9 times pay, 85% replacement ratio) of his or her projected pay at retirement. In this way, we can compare the retirement resources and needs of employees retiring at different times in the future and at different compensation levels. In this report, a single value for retirement needs, resources, or surplus/shortfall represents the average of the results for every individual in the reported group.

Total retirement resources are the single-sum values of amounts projected to be available to employees at retirement. Our studies measure retirement resources from three sources—employer defined contribution plans (both employee and employer money), current employer defined benefit plans, and Social Security.

Retirement needs are the sum of money an average employee needs at retirement to last through all his or her retirement years. We define retirement need as the amount that would allow the employee the same amount of spendable income before and after retirement.

Conclusion

This paper highlights that sponsors and participants are in the retirement readiness business together. Sponsors can help participants achieve their retirement “objectives” through a custom DC investment lineup design. This includes re-enrollment, a custom target date fund, and a streamlined set of objective-based funds in the core lineup.

Customizing DC investment lineups enhances participant retirement outcomes:

- 1. Choice architecture.** Improving plan engagement
 - 3–4 investments are selected by participants, regardless of menu size
 - 3%–4% dip in participation when there are more than 6 investment options
- 2. Open architecture.** Building more sophisticated asset allocations
 - 94% of performance is driven by asset allocation
 - 63% of participants build their own asset allocation
 - 0.8x–4.1x final pay is lost due to suboptimal asset allocations
- 3. Improved governance.** Accessing optimal investment pricing and more control
 - Plans using retail pricing could help participants increase their balances by as much as 1.6x final pay by additionally accessing institutional pricing
 - Improved flexibility with participant communication simplifies the asset allocation process for participants and increases likelihood of achieving investment objectives
 - Implementing a DC dashboard enables the plan sponsor to measure and monitor the committee's objectives for participant retirement income adequacy

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