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With so many new and innovative investment vehicles, strategies and plan features gaining momentum, it seems that the defined contribution world is on the brink of a watershed moment for innovation. But in a litigious world, how does one embrace innovation without fear?

"Plan sponsors understand the benefit of innovation, but the appetite is still comparatively low, largely because of perceived litigation risk for first movers," said Rick Fulford, executive vice president and head of U.S. retirement for PIMCO. "Unfortunately, the risk of litigation has some plan sponsors narrowly focused on driving costs lower, at times at the expense of participants’ best interests. With careful analysis, however, there is an opportunity to achieve both goals — improving participant outcomes while also reducing plan costs."

The focus on outcomes rather than costs is one of the great recent innovations in the world of defined contribution plans.

"Sponsors now have a goal in mind of retirement readiness and improving participant outcomes, which is not the historical mindset," said Josh Cohen, PGIM’s head of institutional defined contribution. "The historical mindset had much more of a retail focus, providing a few interesting features and lots of name-brand options, without much thought to the outcomes that were going to result."

The new focus on outcomes is helping plan sponsors and investment managers identify areas ripe for innovation. PIMCO’s Fulford sees low-hanging fruit in consolidation of fixed-income options on the core menu, where participants have too many sub-strategy choices and could achieve better outcomes if given access to a smaller set of optimal "go anywhere" bond strategies. Another easy win for plan sponsors, in his view, would be to more selectively employ active and passive strategies: favoring passive in certain equity strategies (to cut costs where manager alpha has been less persistent) and favoring active fixed income (where manager alpha has been more persistent).

INFLECTION POINT FOR DC PLANS

Many catalysts are pushing the DC world toward an inflection point when it comes to much-needed innovation, the first being demographics. More than 60% of DC assets are with participants over the age of 50, and approximately 20% of the U.S. population will be 65 by the year 2030, according to Yaqub Ahmed, senior vice president and head of defined contribution-U.S. for Franklin Templeton Investments.

"At the same time, we’re seeing a dynamic regulatory environment in which retirement income rollovers are going to be more highly scrutinized," Ahmed said. Each year, he added, the U.S. DC system sees more than $300 billion in distributions, most of which is not being properly annuitized or integrated within a more comprehensive retirement income strategy. "We are past the point of in-plan income solutions being a ‘nice-to-have,’" he said.

In another evolving area, low-cost vehicles are finally working their way down market in the form of white-label best-of-breed strategies for mid-sized and smaller plans. Dennis Heinke, Franklin Templeton’s vice president for North America product strategy, is excited about DC plan advisers, primarily registered investment advisers, using new, low-cost structures such as collective investment.
trusts to manufacture and deliver “best-cost, institutional-quality funds.” These would be open architecture, multi-manager funds in an institutional vehicle that smaller plans are only now gaining access to.

It’s hard to overstate the potential for innovation with these new best-of-breed fund structures. David Skinner, defined contribution practice leader at PGIM Real Estate, pointed out that private real estate capabilities have been offered in DC plans for over a decade, but primarily in target-date funds.

“Most of the conversations we are having today focus on the use of private real estate together with real assets for inflation-protection strategies across a range of white-label funds,” Skinner said. “So the innovation is not embracing investment in private assets, but the broader use of those assets across the menu, incorporated into multi-asset, multi-manager, outcome-driven portfolios.”

TECH DRIVING CHANGE

While DC plans have been slow to innovate due primarily to fee sensitivity and risk mitigation, technology is driving rapid change across the financial services industry. As the cost of building technology interfaces for users comes down, as capabilities of digital media expand and as providers explore blockchain technology, DC plans have an opportunity to reach participants with more and more customized offerings.

“When I think about what’s best for participants, it’s going to be all about personalization at the end of the day,” said Ahmed of Franklin Templeton. “I truly believe that fintech, such as managed accounts, is going to be the foundation for the next frontier of innovation and a key to better outcomes for participants and their households.”

CONTINUED ON PAGE 6

CHANGE IS IN THE AIR

Despite obstacles, many asset managers believe that the world of DC plans is on the brink of exciting breakthroughs. Below is a partial list of innovations gaining steam across the industry—all focused on improving outcomes while also managing costs.

• Greater use of white-label portfolios
• More thoughtful blends of active and passive
• More open architecture/multi-manager funds
• Expanded use of low-cost vehicles such as collective investment trusts
• Revamped design of target-date funds
• Low-cost fund offerings from registered investment advisers and non-traditional manufacturers
• Professionally managed options for smaller plans
• Personalization enabled by technology
• Improved communications based on cutting-edge language research
• Robust retirement tiers to keep participants in-plan
• Income solutions for retirees
• Application of real assets and alternatives to a wider range of investment challenges
• ESG as an investment philosophy rather than a fund screening tool
• Greater focus on integrated financial decision-making (e.g., financial wellness)
Finally, the culture of the DC market is being shaped by new attitudes about the scope of employees’ financial needs and objectives. A case in point is the slow acceptance of environmental, social and governance factors in investment management. “It’s still controversial, but ESG feels to me like a big swell in the middle of the ocean that’s forming into a tidal wave,” said Greg Jenkins, head of institutional defined contribution at Invesco. “It’s growing slowly, but my message to the industry is: ESG is important. It’s global in nature. And it’s coming. We’re seeing evidence that more people care about ESG issues — particularly young people, women and participants in certain industries and geographies.”

To be sure, Jenkins is not referring to first-generation solutions, such as stand-alone ESG funds or ESG as an elimination screen. Rather, he said ESG is more appropriately used as part of the selection process for stocks and bonds, i.e., that a manager’s thesis on individual holdings would partly reflect ESG tenets.

FOCUS ON VALUE, NOT COST

Another new attitude slowly gaining acceptance, though still a swell in the ocean, is a recognition of financial wellness as a potential key to better outcomes.

“It’s an area ripe for innovation and expansion,” said Kevin Murphy, senior vice president and national retirement plan strategist for Franklin Templeton. He said he believes that record-keepers and financial advisers can deliver comprehensive wellness solutions, and that plan sponsors should view 401(k) plans as one piece of a larger financial solutions platform.

“Financial wellness is really just a technology platform combining multiple aspects of an individual’s situation, including their 401(k), health savings account, budgeting, debt management and emergency funds to name a few,” said Murphy. “That’s really where sponsors need to be focused, because it can improve plan design and ultimately lead to better participant outcomes.”

“There is at least a perceived fiduciary concern from a lot of plan sponsors, stemming from fear of litigation, leading them to emphasize the simplest, lowest-cost offerings available,” said PGIM’s Cohen. “But if you just keep it simple, passive and inexpensive, we believe that sponsors may not be meeting their fiduciary obligations because they’re not giving participants thoughtful use of potentially beneficial strategies.”

He said he believes that in addition to the fiduciary argument, there is a fairness argument to be made in favor of innovation.

“[If plan sponsors can add value to the plan, delivering American workers an institutional approach and fiduciary oversight at a very reasonable cost, much lower than they could get on their own, is it fair to deny them?]” Cohen asked. “Especially if this kind of innovation might improve outcomes for participants, which gets to the heart of the sponsor’s fiduciary obligation.”

A focus on value — measured by improved outcomes — can also help sponsors see past stale binary choices that may have held them captive in the past. Active or passive. Traditional or non-traditional.

“For example, many sponsors are moving to passive equity strategies to lower plan costs, but they are leaving a lot of potential benefit for participants on the table,” said PIMCO’s Fulford. “By employing a more capital-efficient approach through enhanced equity strategies, they achieve both the low cost of passive equity investing and the potential outperformance of active fixed income.”

“There’s always going to be more to do on the innovation front,” said Jenkins at Invesco. He said he believes that most DC plan challenges are rooted in behavioral economics and trying to get each participant on the optimal path to retirement.

“Streamlining the investment menu through white-labeling, introducing post-retirement investment options and tackling a wide range of communications challenges with things like gamification and digital media — sponsors considering any of these innovative approaches should focus on value,” he said. “It’s always a cost-return tradeoff. Do the benefits of innovation outweigh the costs? In many cases they do.” •
There’s an innovative idea: Defined contribution plan menus can be both simpler and more sophisticated. How? Shrink the number of options while building discrete tiers of funds appropriate for specific groups of participants. That is an idea that is finding favor among plan sponsors and appears to be working.

For 11 years, PIMCO has been surveying consultants and large advisory firms about DC plan design, and respondents consistently say that the right number of options for a core menu is about half of what it is today — roughly 10 options, compared with an industry average of about 20.

“Research suggests that as the number of options declines, a plan’s participation rate tends to go up, so there is a clear benefit in rationalizing the number of menu options,” said Rick Fulford, PIMCO’s executive vice president and head of U.S. retirement. “Rationalizing investment options can also help to address participant behavioral issues, such as misallocating risk, naively investing across all options equally or favoring recent performance.”

In addition, Fulford said that the industry has coalesced around a tiering structure that makes sense for most plans. Tier one (the “do it for me” tier) typically includes qualified deferred investment alternative options, such as target-date and/or target-risk funds, and managed accounts. Tier two encompasses the core funds lineup. Tier three, designed for more independent and/or sophisticated “do it myself” participants, may include a brokerage window. Fulford said the industry is headed toward adding a fourth tier as well, one with decumulation/retirement income for participants already in retirement.

BEING SOPHISTICATED ABOUT INNOVATION

While menu simplification and tiering have long been topics in the defined contribution space, one has to be thoughtful about implementation to deliver the most benefit to participants. For example, in today’s market environment of secular low interest rates, which are marching higher, how does one build an appropriate bond offering?

“Consultants consistently tell us that core menus have too many bond offerings, and we agree that the target number should be about two,” said Fulford. “A well-designed fixed-income menu would certainly include a core bond strategy benchmarked to the Bloomberg Barclays U.S. Aggregate Index, but what should the second option be? In our view, the obvious addition would be a go-anywhere, multi-sector, globally oriented strategy with an income orientation. Given the low level of rates today, pairing a core bond...
strategy with a multi-sector, income-oriented bond strategy may provide a more optimal blend of interest rate risk and yield, which we think in the forward-looking environment will serve participants better."

Fulford said he believes that so-called go-anywhere bond strategies also offer the opportunity to consolidate a range of non-core bond options (e.g., emerging markets, high yield and investment-grade credit, etc.) into a single, more optimal offering. “The consensus among plan sponsors is beginning to coalesce around the use of multi-factor bond strategies in this regard,” he said.

“Based on focus groups we’ve conducted, participants want choice and they want to feel that they have some control, but you’ve got to help simplify the decision-making process,” said Greg Jenkins, head of institutional defined contribution at Invesco. “Most plan sponsors understand that it’s not about the absolute number of investment options,” he said. “Instead, they need to focus on what their participants are accustomed to and their level of sophistication.”

When Jenkins talks to plan sponsors at technology companies on the West Coast, for example, they say their participants expect more options and seem to be more comfortable with that. So making the most of innovative new menu designs may require thinking through age, industry and regional differences of the plan’s participant base.

Caution is especially valuable when thinking about older participants, who may need more choice. “As older participants’ needs diverge from one another, based on individual circumstance, they may actually want and need more choice,” said Drew Carrington, senior vice president and head of institutional defined contribution at Franklin Templeton Investments. “Indeed, an overly simplified system of tiers and fund offerings may harm these investors by not giving them the tools they need to achieve their objectives.”

Further, sponsors should shy away from the all-or-nothing thinking that drives many tiering structures, according to Carrington. One cannot assume that participants land in one bucket at a time and move sequentially through each tier. As participants age, and as their balances get larger and their needs more complex, many span multiple tiers, keeping part of their balance in “do it for me” while adding allocations to other tiers.

Finally, Carrington cautioned that tiers need to be more than just investments: “The tiering concept should be broader and include targeted communications, tools and coaching, and plan design changes, along with thoughtful investment options.” (See chart.)

DON’T MISS THE FOREST

“I’ve been working with DC plans for 20 years and what we see consistently is that whenever a sponsor adds a new option to a menu, it often gets either underutilized or mis-utilized, leading to disappointment on the part of the sponsor,” said Josh Cohen, head of institutional defined contribution at PGIM. Today, menu simplification and tiering strategies look like a promising response to plan sponsors’ constant challenge: overcoming participants’ behavioral hurdles to deliver better retirement outcomes.

Yet in designing these solutions, plan sponsors should not miss the forest for the trees.

“Ultimately, the intended use of all these innovations is better outcomes. And that’s more important than the sheer number of funds or tiers, or any rigid divisions of participant populations into tiers,” Cohen said. “What’s most important is that each participant has the right tools at each stage of their life.”

Early in someone’s career, the tier should include diversified, growth-oriented portfolios with education about savings. As one gets closer to retirement and key risks shift toward shortfall and sequencing, it becomes logical to use diversified portfolios that include private markets to help dampen volatility and reduce drawdown risk.

Finally, in retirement, participants shift their focus to addressing inflation and longevity risk, potentially by focusing on real assets to help preserve purchasing power while also generating income.

According to Cohen, “There is evidence that when professionally managed portfolios — such as multi-strategy white-label funds, default options like a target-date funds, or managed accounts — are utilized within appropriate tiers, sponsors are more satisfied that these new offerings are being used in appropriate ways to drive better outcomes.”

### Hypothetical Retirement Tier: More than Just Investment Options

<table>
<thead>
<tr>
<th>1. TOOLS AND COACHING</th>
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<tbody>
<tr>
<td>Social Security Optimizer</td>
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<td>Expense Assessment Tool</td>
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<td>Resource Center (e.g. reverse mortgage, Medicare)</td>
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<th>2. TARGETED COMMUNICATIONS</th>
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<tr>
<td>Catch-up contribution “second escalator”</td>
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<tr>
<td>Invite mid-career hires to save at higher rates</td>
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<tr>
<td>Invitation to use targeted tools</td>
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<tr>
<th>3. INVESTMENT OPTIONS</th>
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<tr>
<td>Laddered/Defined Maturity Bond Funds</td>
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<td>Managed Payment Funds</td>
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<tr>
<td>Inflation Protection</td>
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<tr>
<td>Insurance Solutions</td>
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<th>4. PLAN DESIGN CHANGES</th>
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<tbody>
<tr>
<td>Allow for partial ad-hoc withdrawals</td>
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<tr>
<td>Allow terminated participants to continue loan repayment</td>
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Source: Franklin Templeton Investments
We believe diversification across investment strategies—active, passive and factor-based—is just as important as diversification across asset classes.

- Duy Nguyen, Chief Investment Officer and Portfolio Manager

The innovation is in the diverse combination of strategies.

Invesco Peak Retirement™ Funds

Invesco Peak Retirement™ Funds blend active management expertise with the diversification and cost efficiencies of passive and factor-based investing. The goal: to seek better risk-adjusted returns for participants. Factors are characteristics of securities such as value and quality that may help enhance returns at different points in the glide path.

Along with our new glide path thinking, enhanced inclusion of alternatives and active volatility management, this proprietary combination of strategies has helped create one of America’s most innovative target date funds.

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A target date fund identifies a specific time at which investors are expected to begin making withdrawals, (e.g., Now, 2020, 2030). The principal value of the fund is not guaranteed at any time, including at the target date.

Diversification does not guarantee a profit or eliminate the risk of loss.

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the fund(s), investors should contact their advisors for a prospectus and/or summary prospectus or visit invesco.com/fundprospectus.

Invesco Distributors, Inc.
In many ways, target-date funds revolutionized the defined contribution marketplace, making institutional-quality portfolio allocation available to millions of DC plan participants. But the industry may be resting too comfortably on its laurels.

Three key problems are challenging plan sponsors and fund providers to up their target-date innovation game. The first problem is equity-heavy glidepaths with too much tail risk.

“Unfortunately, when I look at the target-date universe, what I see is a very commoditized market that’s competing on a couple of drivers and leading us off a ledge of risk,” said Dennis Heinke, vice president of North America product strategy for Franklin Templeton Investments. “As an industry, we have competed on two points: How much equity we can shove into a portfolio during an equity bull market, and how we can compete on price.” He said he believes that the industry can and should work to reinvent target-date funds and make them more risk aware, more risk appropriate and better able to address sequencing risk for retirement investors.

“Target-date funds need to strike the right balance of finding efficient growth to last what could be many decades in retirement at the same time that individuals are very vulnerable to drawdowns, particularly right at the point of retirement,” said Josh Cohen, head of institutional defined contribution for PGIM.

“Managing risk at the point of retirement is critical because there are certain individuals, depending on the market environment, who will never recover from a significant drop.”

A recent PIMCO survey found that, in the view of consultants, most DC plan participants could withstand a maximum drawdown of 10% in the years just prior to retirement. But in 2008, pre-retirees in the at-retirement sleeves of the largest target-date funds experienced a drawdown of more than 35% — more than three times the consultant-recommended maximum drawdown.

According to Rick Fulford, executive vice president and head of U.S. Retirement for PIMCO, “Drawdown risk of this level shouldn’t be surprising when you consider that these in-retirement target-date vintages average a 50% allocation to equities.”

Franklin Templeton’s Heinke cited another eye-catching statistic: Even today, the three largest 2020 funds on the market — funds that are supposed to support retirement just two years from now — have an average portfolio allocation of 55% to equities. While he does not see an immediate catalyst for a major recession, the U.S. is at the end of a prolonged business cycle, and equity markets did experience a correction in early February. He said eventually another crisis event like 2008 will hit: “It’s a substantial risk for DC plan participants that’s not well understood.”

So what can be done to reduce equity tail risk in target-date portfolios?

According to PIMCO’s Fulford, “We believe that managing drawdown risk and shielding participants from the worst possible outcomes require reducing allocation to equities, maximizing benefits of diversification and employing explicit downside and tail-risk hedging approaches. At that stage of the participant’s life, the focus should be on income production, which could smooth returns and provide much-needed retirement income in the current low-return environment.”

It also means using more of the tools available to fund managers.

“Plan sponsors should be thinking about diversification first because that’s really what U.S. DC plans are lacking,” said Greg Jenkins, head of institutional defined contribution at Invesco. “The industry has done a poor job addressing the volatility and tail risk posed by high equity allocations in target-date funds.”

It’s easy in the current market environment to envision a long-term scenario in which stocks and bonds deliver returns lower than investors are earning today, at the same time that market volatility is increasing — making it extremely important to find return streams that are unrelated and uncorrelated to both stocks and bonds.

“In this kind of environment, plan sponsors may need other sources of returns potentially in the form of alternatives,” Jenkins said.
At the end of a 40-year fixed-income cycle, bond market tailwinds will become headwinds as rates start to rise, so plan sponsors should also be concerned about fixed-income underperformance. Heinke of Franklin Templeton suggests using Barra risk factors (e.g., earnings growth, liquidity, momentum, leverage) to add uncorrelated assets in a mix that won’t increase risk.

Further, Heinke suggested that the industry needs to take a big step back and rethink performance benchmarking for target-date funds. “It becomes a horse race of quarterly competition and causes managers to pile into equities,” he said. “Maybe the glidepath shouldn’t even focus on the percent in equity and fixed income, but instead focus on overall risk allocation.”

TOO GENERIC
The second key issue is the tendency of plan sponsors and fund providers to think in all-or-nothing terms. “With respect to glidepath design, there’s a bit of a herd mentality out there, in that many look very similar,” said Invesco’s Jenkins. “Why does a target-date fund series have to be all active or all passive? It’s very hard to argue that the best approach isn’t a hybrid one, where you include elements of passive, active management and factor-based investing. There’s a pretty strong argument that all three of these approaches can help in different parts of a glidepath.”

PIMCO’s Fulford cites data from BrightScope, a financial information and technology company, to drive home the point: 98% of target-date funds that are used as a plan’s qualified default investment alternative employ underlying strategies that are either entirely passive or entirely active. “Only 2% of target-date QDIAs use a blend of active and passive management,” he said. “Conversely, if you look at core menus for those very same plan sponsors, you find that over 60% of plan sponsors use a blend of active and passive.”

The forward-looking trend points toward a greater embrace of the active-passive mix, according to PIMCO’s 11th annual DC Consulting Survey. “Our survey of the most influential DC consultants and advisers suggests that an active-passive blend target-date approach is recommended more than any other type,” Fulford said.

Target-date glidepaths also tend to be conservative across the entire glidepath or aggressive across the board, according to Invesco’s Jenkins.

“In a recent focus group, a young participant asked, ‘Why do I need to be invested in fixed income at all at my age?’” Jenkins said. “And he had good point. Why does a 25-year-old in a 2065 fund need a 10% to 15% fixed-income allocation in their portfolio? The industry needs some new thinking around these issues.”

That raises the issue of customization — another potential area of innovation for target-date funds. “Innovation is still greatly needed in the mix of investments underneath the hood of target-date funds, as well as continued customization, driven by technology, at both the plan level and an individual level,” said PGIM’s Cohen.

To illustrate the challenge, and potential solutions, PGIM Real Estate’s defined contribution practice leader, David Skinner, breaks down the evolving use of real estate across the entire target-date glidepath: Real estate, in the form of publicly traded real estate investment trusts, is particularly useful in the participant’s accumulation phase, but private real estate could also be used as a diversifying asset class within the equity bucket. Then as one progresses along the glidepath and starts derisking, especially in the five years preceding retirement, one would overweight private markets for downside protection and underweight public REITs.

“In the future, however, another level of innovation could come in the form of higher-returning opportunistic private real estate, used at the front end of the glidepath as an aggressive growth strategy and potential alpha diversifier,” Skinner said.

In sum, target-date funds need a new round of innovation. Thankfully, many tools are readily available. Once the poster child for innovation, target-date funds could end up looking very different when plan sponsors and fund managers see their way clear to rethink this DC plan staple.

“Eventually, target-date investing may be supplemented by dynamic QDIA structures,” said Franklin Templeton’s Heinke, “where somebody migrates, either based on age or account balance or proximities to retirement, from a sort of generic one-size-fits-all target-date fund into a more customized structure, like a managed account that can incorporate some of these other asset classes in ways that are relevant for particular populations.”
Retirement Income: Late Innings in a Long, Scoreless Game

Lots of innovation but little action in solving nagging issue

Retirement income is one of the hottest areas of innovation in the defined contribution world, where plan sponsors are hungry for solutions to a vexing and long-standing problem.

“First of all, you have more plan sponsors encouraging participants to stay in the plan,” said Greg Jenkins, head of institutional defined contribution at Invesco. “Then you have a realization that there is not going to be a magic solution for post-retirement.”

The success of auto features in addressing a savings problem and of target-date funds in addressing allocation challenges may have given the industry a false sense of confidence that a one-stop solution could be found for the retirement income issue as well. But according to Jenkins, virtually all key industry players — plan sponsors, record-keepers, investment managers — have come to realize that the quest for a single solution is always going to come up empty. There is no such thing as a super-low-cost, guaranteed retirement income vehicle with no issues in terms of portability or usability by in-plan retirees.

“Accepting that reality has actually freed us all to figure out how we can work together to develop a range of post-retirement options,” Jenkins said. “It also frees us up to consider a whole range of ancillary issues, like how we present those options to participants, how we deliver a menu of choices without making it too confusing and how we can keep younger participants from delving into options that are not designed for them.”

A QUESTION OF BALANCE

Designing a viable income tier for DC plan participants is a balancing act that requires simultaneously addressing a participant’s growth, capital preservation and liquidity needs.

“Very few people would argue that retirees do not need growth assets, and even fewer would argue that retirees should be maximizing their allocation to growth assets,” said Josh Cohen, head of institutional defined contribution at PGIM. “The key is finding that right balance where you need efficient growth to last what could be many decades in retirement at the same time individuals are very vulnerable to drawdown risk, particularly right around that point of retirement, where it’s very difficult to recover from a significant drop in account values.”

To find that balance, according to David Skinner, PGIM Real Estate’s defined contribution practice leader, plan sponsors are looking to other potential growth assets beyond equities. Private markets can play that diversification role, with different types of assets utilized at different points along the retirement glidepath.
For example, publicly traded real estate investment trusts often play a diversification role early in the accumulation phase, when younger employees can have extremely high allocations to equities of 90% or more. But as older participants start derisking and enter a capital-preservation and inflation-protection mode — five years or so before retirement, when drawdown risk is high — they are better off over-weighting private real estate and underweighting REITs.

“Real assets like private real estate can help pre-retirees balance investment attributes such as downside protection, inflation protection, income generation and growth that’s not linked to equity markets,” said Skinner. He pointed out that in the last 20 years, direct private real estate has experienced much less drawdown risk than stocks, public real estate and even bonds. (See chart.)

In helping retirees and pre-retirees balance a diverse set of needs, plan sponsors and investment managers are also grappling with the challenge of how to deliver income from portfolio yield, as opposed to drawing down principal.

“Many of the available retirement income products in the market today are simple drawdown funds targeting 3% to 5% payouts, when the underlying portfolio yield is, in many cases, below 2%,” said Rick Fulford, executive vice president and head of U.S. retirement for PIMCO. “That means the vast majority of the payout from those investments is coming from the drawdown of principal. This is not what participants want. So to me, a key ingredient missing from most retirement income solutions is an appropriate focus on income generation.”

Moreover, Fulford said that the income component of target-date funds also falls short in principal protection — i.e., failing to provide enough diversification to guard against drawdown risk. His evidence is that the income sleeves of today’s largest target-date funds — one of the most widely used retirement income solutions in DC plans — have a 50% allocation to equities.

“I believe that’s too much risk for a participant on the verge of entering retirement,” Fulford said. “Participants need access to diversified, globally oriented, market-based retirement income solutions that focus on three things: the production of income, a measure of principal protection and asset longevity, as opposed to focusing just on insurance guarantees.”

‘23RD INNING’

“In the DC world, we talk a lot about climbing this mountain and accumulating assets inside of these plans, but no one has yet worked out how to get down the mountain safely,” said Drew Carrington senior vice president, head of institutional defined contribution at Franklin Templeton Investments. “I heard someone say recently that we are in the early innings when it comes to retirement income, but for many of us it feels like the bottom of the 23rd inning of a 0-0 game. We need to do something.”

And it seems that abandoning thoughts of a magic bullet has opened the door to a range of possible solutions — each one imperfect and incomplete on its own, but together offering the hope of finally making headway on the income challenge. Asset managers alone cannot solve the problem, nor can insurance companies or record-keepers on their own.

“It’s our responsibility as an industry to sit down and collectively create the solutions that are going to be most beneficial,” said Yaqub Ahmed, Franklin Templeton’s senior vice president and head of defined contribution-U.S. “We will also need the continued support of regulators, with direction on safe harbors and other critical issues.” But he is optimistic that the Department of Labor and the Trump Administration see this as a priority.

### Seeking Downside Protection: Number of Quarters with Negative Total Return

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<th>Asset Class</th>
<th>Number of Quarters</th>
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</tr>
<tr>
<td>REITs (NAREIT)</td>
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<td>Bloomberg Barclays U.S. Agg.</td>
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Source: PGIM Real Estate. As of Sept. 30, 2017. Past performance is not a guarantee or a reliable indicator of future results. Data covers 20 years of quarterly returns.

Ultimately, Ahmed envisions income and decumulation solutions with multiple components — partly guaranteed, but at competitive prices, not overly expensive; partly market-based offerings without guarantees (e.g., low volatility solutions, short-duration fixed income for predictable and fixed expenses in retirement). “There are many different vehicles and investment approaches, active and passive, that will be required, and the industry must consider them all,” he said.

Ahmed also believes that DC plan advisers and consultants may have the hardest job: bringing it all together in partnership with asset managers and other providers. This new quest will focus on building technology platforms that deliver a range of tools — and personalized solutions — for a fast-growing and heterogeneous group of participants over 50 years old.

“The needs of U.S. workers and their families are complex,” he said, “and we can’t work under the assumption that one size fits all.” •
They Can’t Hear You Now

Defined contribution plan participants may not be getting the right message on innovation

You say one thing. They hear something completely different. People miscommunicate all the time. But when an employee’s savings and retirement goals are at stake, it’s worth taking a second look at how and why communications go awry.

“We tested the word ‘innovation’ in our language studies and found that it’s not a great word because people are immediately skeptical of change,” said Gary DeMoss, director of Invesco Consulting. “When it comes to any new features or options being introduced, they are universally viewed as a negative. So you definitely don’t want to lead with a message of ‘new and improved.’”

He said that when it comes to employee benefits, participants take the message of “new and improved” to mean reduced benefits at higher cost — just think about corporate health plans, with their expanding premiums and shrinking coverage, and you’ll get the idea.

“DC plans have gotten much better over the years, but we are facing a communications headwind any time we try to introduce something new because participants are automatically going to assume that there’s something negative coming,” DeMoss said.

Participants feel the same way about anything with the term “auto” in front of it, he said. When a sponsor says “automatic” or “default” (no matter how innovative or helpful the feature may be), the participant hears it as “loss of control.” The word “costs” works better than “fees.”

“Just think about all those mysterious ‘fees’ on your cellphone, hotel, and cable TV bills,” he said.

Four key attributes of good communication that DC plan sponsors should embrace:

1. Positive: Don’t sell fear. Participants want a hopeful message — to hear how any change is going to benefit them.
2. Plausible: Offer credible potential benefits. For this reason, terms like “financial freedom” and “dream retirement” do not score well with participants. They just don’t ring true.
3. Plain English: Avoid jargon. Participants want benefits and concepts explained clearly, in a way that is easy to understand.
4. Personal: Personalize the potential benefit. Lead with a message of “What it does for you,” not “What it is.”

Source: Invesco Consulting

Results based on the firm’s ongoing financial language research with Maslansky + Partners from 2007-2018 that included over 12,000 investors surveyed. Material is for illustrative, informational and educational purposes only.
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