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SPONSOR DIRECTORY

Bentall Kennedy
7315 Wisconsin Avenue
Suite 200W
Bethesda, MD 20814
www.BentallKennedy.com
Josh Samilow
Senior Vice President
202.737.8826
jsamilow@bentallkennedy.com

Franklin Templeton
One Franklin Parkway
San Mateo, CA 94403
www.ftinstitutional.com/dc
Drew Carrington, CFA, CAIA
Senior Vice President
Head of Institutional DC
650.312.4396
drew.carrington@franklintempleton.com

PGIM Real Estate
7 Giralda Farms, 3rd Floor
Madison, NJ 07940
www.pgimrealestate.com
Sara Shean
Executive Director, Defined Contribution
703.304.0438
sara.shean@pgim.com

PIMCO
650 Newport Center Drive
Newport Beach, CA 92660
www.pimco.com
Rick Fulford
Head of U.S. Retirement
949.720.6529
rick.fulford@pimco.com

S&P Dow Jones Indices
A Division of S&P Global

S&P Dow Jones Indices
55 Water St.
New York, NY 10041
www.spdjii.com
Jodie Gunzberg, CFA
Managing Director, Head of U.S. Equities
jodie.gunzberg@spglobal.com

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CONTENTS

4
CUSTOM STRATEGIES
POISED TO GO MAINSTREAM

8
GLIDEPATH INNOVATION

12
RETIREMENT INCOME:
ON THE CUSP OF A
BREAKTHROUGH?

15
INDEXING FOR
RETIREMENT INCOME

17
EXPANDING
INTO NEW
TERRITORY

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CUSTOM STRATEGIES POISED TO GO MAINSTREAM

Smaller Menus Need More Robust Options, Sparking Interest in Custom and White-Label Funds

Once dominated by big defined contribution plan sponsors that have experience with a broader universe of investment options, custom target-date and white-label funds are becoming a more common feature in smaller DC plans, thanks to large registered investment advisers, outsourced chief investment officer, or OCIO, relationships and aggregators.

“These kinds of innovative, value-add solutions include better diversification, largely coming through an expanded asset mix within the [qualified default investment alternative],” said Josh Cohen, managing director for defined contribution at PGIM.
“Larger institutional investors use a thoughtful mix of active and passive management, and appreciate the benefits of diversified asset classes,” he said. “That framework is now being applied to the defined contribution market, as opposed to an approach that says let’s just keep it simple and cheap, because that latter approach won’t necessarily always result in the best outcome for participants.”

Every year, PIMCO conducts a comprehensive consultant survey that includes a section on custom and white-label options. The most recent data show that the steady increase in the use of white-label funds has outpaced growth in the use of custom target-date funds.

“This survey is pretty close to what I would say is consensus in the consulting community, if there is such a thing,” said Rick Fulford, PIMCO’s head of U.S. retirement. “White-label funds hold more than double the assets of custom target-date funds, with nearly twice the expected growth.”

Another key driver of this trend is the continued consolidation of DC plan menus, which have fewer options in order to help participants make better choices and lower costs for plan sponsors. A menu’s fixed-income selection is a good place to look at the potential impact of white labeling.

Case-in-Point: Fixed Income

“Consultants and advisers generally recommend two bond options on the menu, one being a core strategy,” Fulford said. “But in the current environment of low interest rates, a typical core portfolio has much lower yields and higher interest rate exposure than it did a decade ago. So the other bond mandate should complement and diversify those risk factors. As a result, we see strong interest in complementing core bond exposures with multi-sector bond strategies that emphasize income production and capital preservation but with less interest rate risk. And when you combine those two, you tend to end up with a more optimal allocation, with returns somewhere between the two but risk in line with that of core bonds.”

The push to offer more robust options on DC menus may be opening the door to mass customization, with distributors, advisory firms, RIAs and other players enhancing their value proposition by creating white-label funds that are both multi-manager and a thoughtful blend of active and passive. Ultimately these DC plan partners would become asset managers or manufacturers of such strategies. It may even be the smaller plans and their advisers that push the envelope on customization.

“The target-date managers taking these first steps are more the midmarket fund providers, as well as consulting firms that are creating their own glidepaths and understand the value of diversification,” said Josh

CONTINUED ON PAGE 6
Expected Growth of Custom Strategies

Q. To how many clients do you currently provide custom asset allocation services? What are the total assets in those services? What percentage of your clients may implement these strategies over the next three years?

<table>
<thead>
<tr>
<th>CUSTOM SERVICES</th>
<th># of Firms</th>
<th>TOTAL # OF CLIENTS</th>
<th>TOTAL CLIENT ASSETS (MILLION)</th>
<th>EXPECTED CLIENT GROWTH</th>
</tr>
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<tr>
<td>Custom multi-manager/white label</td>
<td>13</td>
<td>292</td>
<td>876</td>
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<td>32</td>
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<td>750</td>
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<tr>
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<td>1,011</td>
<td>23</td>
<td>5%</td>
</tr>
</tbody>
</table>

*Overall increase in assets due to firms that reported figures for 2018 but not for 2017
Source: NACO and Defined Contribution Consulting Support and Trends Survey

Samilow, senior vice president for client relations at Bentall Kennedy.

He said he doubts that the big push toward greater customization will be led by the industry’s household names. That’s partly because the industry’s smaller players are already using a combination of outside managers. What’s more, the biggest players may be less inclined to subdivide their asset sleeves to include specialty managers.

“Because the smaller players are not off-the-shelf, they have to be more solutions based,” Samilow said. “They are much more customized based on demographics, and that’s where we are seeing the most traction, from smaller to mid-market target-date managers, consulting firms and OCIO platforms looking for specialty niche managers.”

**Regulatory Logjam**

The regulatory environment could be holding back greater adoption of custom strategies, but Drew Carrington, head of institutional defined contribution at Franklin Templeton Investments, said he is hopeful there will be a break in the logjam within a couple of years.

He cited as an example a recent Internal Revenue Service private letter ruling that enabled a single plan sponsor to make 401k contributions that match participants’ student loan payments. And he pointed to bipartisan, bicameral support for elements of the Retirement Enhancement and Savings Act bill, or RESA.

“The open multiple-employer plan provision, in particular, creates a mechanism for small employers to come together and participate in an overall larger DC plan,” Carrington said. “We believe that would have a number of positive impacts on participation and coverage.”

“In the middle market, especially if you’re starting up some kind of association retirement plan or multiple-employer plan, you’re not burdened with the inertia of established approaches or strategies,” said Kevin Murphy, head of defined contribution strategic accounts at Franklin Templeton Investments. “New plans that start up are going to be state-of-the-art plans.”

Carrington added that “the Netflix generation expects a certain level of personalization. They are not very impressed when your plan level approach is, ‘You’re 35, here’s your fund.”’
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No one is expecting a replay of 2008, but with a question mark over global growth, and equities exhibiting increasing volatility, one would be remiss not to consider the possibility of an economic slowdown and/or a substantial stock market correction. Fears of a slowdown raise the specter of potential sequence risk for older participants — those just a few years off from retirement.

“We’re not calling for a recession, but you could say we’re nearer to the end of the cycle than the beginning, and in that environment you could argue that risk assets like equities, especially at current valuations, are somewhat vulnerable,” said Rick Fulford, head of U.S. retirement at PIMCO.

While odds of a 2008-type recession this year are low, it is still important to examine the lessons learned back then, when many retirees and pre-retirees took significant hits to their retirement savings. According to Fulford, almost nothing has changed with respect to risk levels in target-date funds, especially in the years just prior to retirement. “There remains a heavy reliance on equities in most target-date funds today,” he said. “There is also an underappreciation for the value of explicit downside risk management.”

The issue is a pressing one because so much participant money is directed to target-date funds as the qualified default investment alternative, or QDIA. That number stands at about 50% of new participant money today and is expected to increase to 85% by 2021.

“Heavy reliance on equity risk works great when equity markets are moving forward nicely as they have for the past five or six years,” said Wylie Tollette, head of client investment solutions at Franklin Templeton Investments. He also pointed out that market volatility can be beneficial when participants are in accumulation mode, as it allows them to dollar-cost-average while building wealth — potentially lowering the average cost basis of their retirement assets. “But as soon as you have a decent size correction, people are reminded that a correction at the...
wrong time, when you’re due to retire, can be very painful and almost impossible to dig your way out of,” he said.

**Strategies to Solve the Problem**

But plan sponsors and their fund providers are not without tools to address such risks. “The issue can at least partially be addressed by taking advantage of diversification,” said PIMCO’s Fulford. “That is, identifying return-driving assets other than equities to potentially contribute to returns over time. Diversification may smooth the ride for investors and potentially keep them invested during a downturn, because the impact on the portfolio may be less dramatic.”

The other strategy he favors is taking a more active approach.

“In this kind of risk environment, we believe it’s appropriate to lean on active management, to potentially compensate for some of the risks in a purely passive investment. That applies on the equity side and more importantly, on the fixed-income side,” he said.

“We all recognize that the vast majority of new participant assets are moving toward the QDIAs, and that there is a real opportunity for diversification that can benefit participants in those funds,” said Sara Shean, executive director for defined contribution at PGIM Real Estate. “There has been little downside over the past several years for taking what in many cases is a `simple and cheap’ approach, because markets have, for the most part, moved directionally upward. But diversification in this specific context — as a way of building in downside protection — is very difficult to get if you are 100% passively invested.”

Shean said she is seeing heightened demand for real estate, not just as an investment sleeve in a DC investment lineup on its own, but also blended with other alternatives as part of a real assets sleeve, which can be used within target-date funds as a QDIA, as well as within white-label funds elsewhere on the menu.

At this moment of heightened risk — or at least the perception of heightened risk — DC plan sponsors are looking at such diversifying asset classes for the same reason defined benefit plans use them.

“Private equity real estate, for example, has been popular within defined benefit plans because of its low volatility, very low correlation to stocks and an income component that has historically been strong, stable, durable and predictable,” said Mike Keating, senior vice president of portfolio management at Bentall Kennedy. “For all those reasons, we’re seeing interest spill over to the defined contribution market.”

Until recently, DC plans could not access private equity real estate because there were no liquid, daily valued vehicles available for this market, and these strategies cannot be replicated by a benchmark. But that is changing quickly, with nearly a dozen providers now working in this space. And interest is growing from outsourced chief investment officer platforms, consultants and large registered investment advisers, who can bring sophisticated diversification strategies to smaller and mid-size plans.

Josh Cohen, managing director for defined contribution at PGIM, pointed out that without diversification, it’s very difficult to address the wide range of risks facing pre-retirees, including sequence-of-return risk.

“You could go to cash, or just a bond portfolio or any number of other strategies,” he said. “But each one exposes you to a range of other risks — from inflation to longevity to duration. Addressing all of these risks takes a thoughtful mix of active and passive, and

CONTINUED ON PAGE 10

ADVERTISING SUPPLEMENT | INNOVATIONS IN DC | 9
diversifying asset classes. Real assets can play an important role here because they have historically done much better in protecting against volatility as well as inflation risk.”

Next-Generation TDFs: Less Autopilot

In its annual survey of consultants, PIMCO asked about their recommended levels of equity risk in retirement portfolios, which gets to the heart of the question about sequence risk. Surprisingly, the responses came back in a very wide range, from 10% to 80%.

“That range is interesting, but what’s most interesting is that the average recommended equity allocation at retirement is around 35%,” said PIMCO’s Fulford. “That compares to an average equity allocation at retirement of about 50% for many of the leading target-date funds on the market. Judging by these numbers, there is probably too much equity exposure in target-date funds today, particularly this late in the cycle, when downside risk is more prevalent than it has been in recent years.”

One way to address equity risk for older participants, as counterintuitive as it may sound, might be to take a target-date fund off autopilot. That approach sounds like it runs counter to the “set it and forget it” sales pitch that makes target-date funds attractive in the first place. But that is exactly what Franklin Templeton believes may be necessary in a shifting economic regime.

“If the market’s risk environment increases — and many people believe we’re in that type of market right now, where the possibility of a recession in the next few years is becoming more real — that might be a time to back down on risk a little bit,” said Tollette at Franklin Templeton. “That doesn’t mean completely backing out of equities, but it may mean a temporary reduction in equities for those closest to retirement, to reduce their drawdown risk, beyond the reductions already in the glidepath.”

Franklin Templeton has created a so-called defensive glidepath that the firm’s target-date managers can shift to in cases of elevated market risk. “The goal is to dynamically manage the risk in the strategy according to what the market is telling us,” Tollette said.

Of course, one could also shift the entire goal of the glidepath from wealth accumulation to income protection, as S&P Dow Jones Indi-

ces does with its S&P STRIDE index series.

“Typical retirement risk measures, like drawdown risk, volatility, or asset class performance, focus on wealth accumulation. But the real risk in retirement is having sufficient income,” said Jodie Gunzberg, managing director and head of U.S. equities for S&P DJI.

She argued that the first generation of glidepath and target-date benchmarks addressed the question of how much a participant needed to save in order to retire. But the more appropriate question should be how much of a participant’s current income does he or she need to save to maintain their current lifestyle through retirement? “Shifting that question shifts the entire risk discussion from a wealth-based approach to an income-based approach,” Gunzberg said.

The tangible result of that shift is a revolutionary glidepath that transitions rapidly from an equity-heavy wealth accumulation portfolio early on, to an inflation-hedged liability-driven investment portfolio at retirement — one with a fixed-income component entirely allocated to TIPS and a zero allocation to nominal bonds. The final equity component of the S&P STRIDE portfolio is also much lower than traditional target-date allocations, and bottoms out at around 20% in retirement.

Reality Check Needed

This switch in glidepath design — aiming to meet a generalized retirement income liability — was not explicitly done to address sequence risk, but the practical result is a faster reduction in equity risk with a strong shift to income-producing assets throughout the glidepath transition and on into retirement.

Of course, older participants may also need to give their retirement strategy a reality check if it includes only one type of vehicle. “Target-date strategies make a good overall foundation, but they often need to be supplemented with other types of assets to make sure that the investor’s overall risk profile is appropriate for their situation,” said Kevin Murphy, Franklin Templeton Investments’ head of defined contribution strategic accounts. “Target-date funds were sold as a kind of one-stop shop. But participants still need to understand and evaluate the risks they might be taking in their target-date fund.” *

CONTINUED FROM PAGE 9

IF THE MARKET’S RISK ENVIRONMENT INCREASES — AND MANY PEOPLE BELIEVE WE’RE IN THAT TYPE OF MARKET RIGHT NOW — THAT MIGHT BE A TIME TO BACK DOWN ON RISK A LITTLE BIT.

Wylie Tollette
Head of client investment solutions, Franklin Templeton Investments

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Retirement plans have come a long way since the Pension Protection Act of 2006, thanks to the collaborative efforts of key industry players. But a new and significant challenge has surfaced that demands equal, if not greater ingenuity and plain old hard work: Retirement income.

“The question is, how do you convert a pool of lifetime savings into a stream of income, consistent with current living standards, that participants can rely upon for the rest of their lives in retirement?” asked Rick Fulford, head of U.S. retirement at PIMCO. “Far and away, I think that’s where innovation is most focused today.”

According to Fulford, the perspective of plan sponsors is changing — showing a greater interest in keeping participants in plan after retirement to take better care of them, as well as gain scale and drive down the plan’s cost of service. In PIMCO’s annual consultant survey, nearly two thirds of respondents (64%) said plan sponsors should have some kind of retirement tier in their plans.

“I think sponsors are starting to come to terms with the fact that we’ve had some pretty good ideas about helping people accumulate assets, but now participants face some unique risks and challenges in the decumulation phase, and perhaps there is a benefit to helping retirees in that phase as well,” said Josh Cohen, managing director for defined contribution at PGIM. “So sponsors are thinking about how to provide different types of solutions: Non-guaranteed and potentially guaranteed investment solutions as well as tools, advice, education. The ultimate answer will not be a silver bullet, one-size-fits-all approach, but instead a combination of capabilities that need to come to bear to help retirees manage their unique risks.”

The proposed toolkit for retirees would have to include investment choices, plan design changes, targeted communication, new technology and a range of other innovations if defined contribution plan sponsors want to create a truly effective retirement tier, according to Drew Carrington, head of institutional defined contribution at Franklin Templeton Investments.

“The needs of this participant group are less homogenous,” he said. Older participants, as a group, can be diverse in terms of their preparedness and the extent to which their current plan balance represents either the majority or even a significant portion of their overall household retirement assets. “So delivering an entire toolkit to this population is important,” he said. “And there is definitely an appetite, as well as the capability, to deliver investment innovation and menu simplification simultaneously. And there's urgency to

CONTINUED ON PAGE 14
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Income Tier Captures Attention

Do you believe plans should offer a separate retirement income tier?

“Could be a separate offering but may include some of the same offerings included in other tiers, depending on plan sponsor/participant demographics, circumstances, employer goals and objectives; may not necessarily be a tier, more like a separate structure—some components of core can be included." Source: PIMCO 2021 Defined Contribution Consulting Support and Trends Survey

Innovative Philosophies and Structures

One of the first challenges in creating a true retirement tier, including delivering viable income solutions, is grappling with the philosophical shift required: toward an income and spending objective, instead of the wealth accumulation objective that has long defined DC plans.

“Typically, target-date and other lifecycle glidepaths increase fixed-income allocations and decrease equity allocations through time to reduce overall portfolio volatility as retirement approaches,” said Jodie Gunzberg, managing director and head of U.S. equities at S&P Dow Jones Indices. “However, the risks that must be considered in an income-focused approach are related to the uncertainty of future income rather than the volatility of wealth.”

To address such a shift in risk philosophy, S&P DJI, in collaboration with Dimensional Fund Advisors, has developed a new family of indexes that can be used to benchmark a potentially new breed of income-focused glidepaths. Following the accumulation phase — and its high exposure to growth assets — the S&P STRIDE indexes shift toward assets that specifically hedge against inflation and changes in interest rates to reduce the uncertainty around the level of consumption one’s savings will be able to afford, according to Gunzberg. (See Indexing for Retirement Income, page 15)

In addition to a potentially revolutionary shift in risk focus, retirement tiers must also take a hard look at participant behavior and plan structure, which present very different challenges when it comes to retirees.

“Retirees tend to consume more when portfolio returns are generated from income versus when the returns are generated from capital gains,” said PIMCO’s Fulford. “There’s no investment rationale for why that’s the case. It’s solely a mental accounting issue, but it has important implications in retirement.”

The upshot of this behavioral insight is that many retirees see capital gains as temporary and are loath to spend them down, potentially resulting in a retirement that has a lower quality of life than it could.

“When developing retirement income solutions, one should be cautious about trying to change human behavior, which we know is very difficult, and rather seek to navigate around it,” Fulford said. That means creating solutions focused on portfolio returns generated by income, which retirees prefer.

According to Fulford, plan sponsors also need to restructure DC plans to be less of a “hostile environment” for retirees. “DC plans almost force participants to roll out into an IRA or some other kind of flexible vehicle, because too many DC plans only allow lump-sum distributions,” he said. “And when assets do remain in the plan, retirees are often charged per-transaction withdrawal fees that can add up to hundreds of dollars per year. Essentially, DC plans don’t allow retirees ready access to their capital.”

Fulford said he believes that to be a true decumulation vehicle, DC plans need to be less punitive, for example, allowing withdrawals and eliminating transaction fees, for starters.

Solutions Coming Into Focus

“The industry also needs to get moving on practical income solutions,” Fulford said. “Perfection has been the enemy of the good as it relates to retirement income, and we just have to move past that now.”

CONTINUED FROM PAGE 12

CONTINUED ON PAGE 16
Indexing for Retirement Income

It’s a revolutionary concept in the defined contribution world — indexing a participant’s retirement liability instead of their wealth — even though the former approach has been standard practice in the defined benefit world for years. Now, S&P Dow Jones Indices believes the time is right to bring liability driven investing-type of indexing to defined contribution plans.

“We try not to build things that aren’t being demanded by the market,” said Jodie Gunzberg, managing director and head of U.S. equities at S&P DJI. “But we have seen increasing demand for DC strategies tied to inflation and interest rate risks, as well as market risk, that put a keener focus on retirement income.”

In 2016, S&P DJI launched the S&P STRIDE index series, which consists of fully investible glidepath indexes aimed at maximizing a generic income stream. Just like any target-date type glidepath, the STRIDE series has three phases: Accumulation, transition and decumulation. And while the first phase might look typical of any target-date glidepath, the latter two reflect new and innovative thinking.

During the accumulation phase, these benchmarks mirror the high equity allocations typical of most target-date glidepaths. Then at 20 years pre-retirement, the glidepath turns to a transition phase that shifts portfolio constituents toward fixed-income and income-producing assets — a typical approach.

What’s unique about the S&P STRIDE series is the steepness of the transition phase, which results in a much lower equity allocation compared to typical target-date strategies. Less than 30% at 65 years old. It is also much less reliant on traditional fixed-income assets, with a zero allocation to nominal bonds in retirement. In the decumulation phase, S&P STRIDE indexes use mostly a duration-hedged treasury inflation-protected securities, or TIPS, portfolio, where the monthly durations match a hypothetical income cash-flow stream lasting for 25 years into retirement.

“Educational pension plans have been using LDI for quite some time, and the basic concept here is the same. That is, figuring out the present value of a dollar for each of the participant’s 25 years in retirement and what portion of the current income needs to be saved,” said Louis Bellucci, associate director of U.S. equities at S&P DJI. “The innovation is the glidepath’s transition from a typical wealth-based portfolio focused on accumulation to an inflation-hedged LDI portfolio focused on income. Those are two very different objectives that require two very different types of portfolios compared with most target-date glidepaths that rely on a single wealth-based portfolio that just dials down equity risk in retirement.”

It’s a novel approach for S&P DJI, which until now has used consensus-driven glidepaths in its target-date index series — i.e., they simply measure the aggregate performance of existing strategies in the marketplace. The S&P STRIDE series, by contrast, uses a proprietary lifecycle glidepath developed by S&P DJI, based on an approximated retirement income liability for a majority of DC retirement plan participants and individual retirement account holders.

These strategies are fully investible, and as Gunzberg pointed out, also beatable. “Just like a large-cap manager might try to beat the S&P 500 benchmark by actively managing constituent weights, retirement fund managers can do the same thing with these indexes,” she said.

What’s most important for participants, according to Gunzberg, is giving them a framework for transitioning from a philosophy of wealth accumulation to one of income protection.

“Those kinds of philosophies are already in place for defined benefit plans, and can now easily be ported over to DC plans, so that everybody can have access to sophisticated income strategies in a simple way,” she said.

“WE HAVE SEEN INCREASING DEMAND FOR DC STRATEGIES TIED TO INFLATION AND INTEREST RATE RISKS, AS WELL AS MARKET RISK, THAT PUT A KEENER FOCUS ON RETIREMENT INCOME.”

Jodie Gunzberg
Managing director and head of U.S. equities, S&P Dow Jones Indices
He said he believes that the industry can get investors a large part of the way toward their goal with carefully designed multi-asset, income-oriented portfolios. He pointed to existing fixed-income products that can produce as much as a 5% annual distribution from income alone, with no capital gains distributed on a monthly basis. “You could put together a pretty attractive multi-asset portfolio that may yield a bit lower than fixed income alone, maybe 3-1/2% to 4%,” he said. “As an adjunct to Social Security, that level of income production, at a modest level of volatility, could address the longevity issue.”

S&P DJI’s Gunzberg brings the discussion back to the differences in risk management between income-focused strategies and wealth accumulation strategies.

“Wealth accumulation strategies focus almost exclusively on managing market risk,” she said. “That means gradually reducing equities and shifting to short-term fixed income. But that approach fails to address effects of inflation and interest rates on a portfolio through time. A more appropriate risk-management approach for income-focused solutions may use treasury inflation-protected securities, or TIPS, matched to the duration of future retirement income liabilities, which can help hedge against inflation and reduce uncertainty around retirement income.”

It’s a novel indexing approach that suggests a new way to design retirement income solutions: Manage market risk appropriately during accumulation, then minimize interest rate risk by duration-matching the income risk with bonds, and finally, protect the purchasing power of retirement income through inflation hedging.

“Designing solutions specifically for a retirement tier can include a range of tools, from managed account solutions to full or partial annuitization to adding asset classes beneficial for decumulation,” said Sara Shean, executive director for defined contribution at PGIM Real Estate. “Assets suited to decumulation — with its income and inflation sensitivities — could include private assets like private real estate and global investments in the private equity and debt space. That would be a new phenomenon in the DC world, but larger plan sponsors and consultants that tend to be first movers are looking in this direction.”

Ultimately a retirement tier may also include different solutions for different types of income objectives, given that retirees often don’t have a single view on income risk. According to Wylie Tollette, Franklin Templeton’s head of client investment solutions, retirees tend to think about retirement income in three levels: What’s needed for survival, what would provide a comfortable living, and what would correspond to their idea of luxury.

“Each of these corresponds to a kind of mental risk bucket and may require unique investment solutions,” he said. “To be effective, retirement tiers may have to offer investment strategies that help people at all different levels of that spectrum, starting with high-probability, lower-risk strategies to provide basic income, and working up to higher-order income goals, where retirees may be able to tolerate more risk.”

Tollette noted that income strategies are available today. Many firms have been offering them for decades, and investors have come to rely on them almost like a paycheck replacement strategy. Such solutions prioritize a consistent, stable level of income over other considerations.

“Many investors are comfortable with the price of an income fund bumping around a little bit more than a bond or a bond fund,” he said. “They are less volatile than a stock or a stock fund, somewhere between stocks and bonds.”

No matter what form these income solutions ultimately take, experts agree on the need for diversification, bringing income into sharper focus, and the importance of professional management.

“Investment solutions will need to play an important role in any retirement offering,” said PGIM’s Cohen. “Whether that means adding income-producing asset classes or building risk-hedging strategies, we need new solutions that offer appropriate risk-reward tradeoffs for older participants. And in that regard, the same institutional management skills are needed post-retirement as they are pre-retirement.” ▶
Expanding into New Territory

In the Quest for Diversification, DC Plans Eye Private Real Estate Markets

While the trend is still in its infancy, defined contribution plan sponsors are pushing into alternative asset classes in a quest for diversification. For decades, institutional investors, such as endowments, foundations and defined benefit plans, have used a wide variety of asset classes, including illiquid assets, in pursuit of a range of portfolio objectives. The story is not the same for defined contribution plans, for a variety of reasons that have to do with availability, cost and perceived fiduciary risk.

“One of the advantages of working in the defined benefit space is that you can invest in a variety of asset classes, many of which are private or illiquid at scale, things like infrastructure, private real estate, private equity and private debt,” said Wylie Tollette, head of client investment solutions at Franklin Templeton Investments and a former executive of one of the largest public pension plans in the U.S. “Those asset classes for the most part are not available in the defined contribution space, and I, for one, would like to see defined contribution plans allow for some limited and well-managed allocation to these other types of asset classes.”

That would require changing the perception of the exposure to fiduciary risk by including alternative assets, according to Tollette. But he said he believes it would provide additional diversification and many of the benefits that defined benefit plans get from those asset classes.

Leaders in the real estate business see this as the future, and they are preparing now to be integral players in the future of DC plans.

“While many people are still covered by DB plans, and these are the retirement industry’s biggest icebergs, they are melting, not growing,” said Josh Samilow, senior vice president of client relations at Bentall Kennedy. Samilow pointed to the fact that today, the vast majority of assets in the NFI-ODCE index, a major real estate investment index, are institutional dollars. “But we’re preparing for a future where defined contribution retirement dollars will exceed defined benefit dollars in terms of assets outstanding,” he said.

With defined contribution dollars expected to dominate retirement savings, Samilow argued that illiquid assets valued quarterly, or even annually, cannot sit side-by-side with daily valued securities on a DC platform. It won’t work from an administration standpoint, a participant-communication standpoint or a regulatory standpoint. Daily valued vehicles are a prerequisite to accomplishing the type of liquidity and ease-of-investment-execution plan sponsors need and expect.

The inexorable shift toward daily valued private real estate has been slowly gaining steam over many years, according to experts at PGIM Real Estate, which has been managing daily valued real estate vehicles for the DC marketplace for more than 12 years.

CONTINUED ON PAGE 18
While the business has grown steadily over more than a decade, we have seen the greatest growth in just the past three years,” said Sara Shean, PGIM Real Estate’s executive director for defined contribution. “It has been fueled by plan sponsors’ increasing appetite for diversification, particularly in professionally managed solutions, like custom target-date or white-label funds, rather than stand-alone menu options.”

She pointed out that privately managed real estate with a daily value is not new, and, in fact, is more common than the average plan sponsor may think. The management and valuation process is well-established, with multiple levels of fiduciary oversight. (See Primer: Daily Valuation of Private Real Estate, page 19)

“A third-party valuation manager provides values for the underlying direct real estate and strikes the [net asset value] on a daily basis,” Shean said. “They actually sign on as an added layer of fiduciary protection, so we are fiduciaries as investment managers and they are fiduciaries as the valuation manager. Combined, this helps give plan sponsors more comfort in terms of the process itself, and the levels of protection they’re getting when they’re wrapping these assets into a solution for participants.”

Increased Efficiency

Of course, plan sponsors don’t pursue diversification for its own sake — they do it for the potential performance enhancements it may offer in participant portfolios. In this case, they are pursuing several complementary goals: Managing volatility, potentially increasing portfolio efficiency and returns, as well as producing income and hedging inflation.

“Defined benefit plans have outperformed defined contribution plans in part because of their heavy reliance on, and access to, illiquid investments,” said Mike Keating, a senior vice president for portfolio management with Bentall Kennedy. “There’s an illiquidity premium associated with these assets because they are not traded on an exchange. The volatility is much lower. The correlation to traditional assets is also low. In addition, real estate has a built-in inflation hedge. In a period of rising inflation and interest rates, in theory, real estate will benefit from higher rents. And in a downturn, the contractual nature of leases may bridge owners of commercial real estate over periods of financial distress. So there are potential hedging benefits to real estate, with lower volatility and potentially more durable returns.”

“One of the most important considerations for plan sponsors, especially right now, is that the diversification they are getting with private real estate comes largely in the form of downside protection,” Shean added.

Downside Protection

The firm’s research shows that adding private real estate to a traditional stock/bond portfolio may lower the maximum drawdown and volatility, while improving returns and the Sharpe ratio across a range of potential objectives, from aggressive to conservative. This result derives in large part from the historical stability of private real estate returns, which have had fewer quarters of negative returns over the last 20 years than traditional stock and bond markets, according to Shean.

“Given the potential improvements in drawdown scenarios, and downside protection, private real estate may help multi-asset vehicles deliver better risk-adjusted returns and a smoother ride for participants overall,” she said.

Out of a large crop of potential diversifiers, real estate may be the most suited to DC plans, given that it’s the easiest to explain to participants, according to Keating. But that does not mean any strategy will do. “First of all, core strategies are the most stable of the private real estate risk profiles,” he said. “Core is somewhat more predictable and stable than value-add or opportunistic or other real estate sectors that can carry more risk.”

He also warned that real estate investment trusts, while cheap, may not deliver the diversification that DC plan sponsors are looking for. Private equity real estate lets investors access the economics of commercial real estate directly. REITs, on the other hand, do not directly track property-level fundamentals of the owned assets — first because of the operating company overlay, and second because REIT values are driven by investor sentiment in the equity market.
How Private Real Estate Can Impact Portfolios

<table>
<thead>
<tr>
<th>Q1 1999 - Q4 2018</th>
<th>RETURN (%)</th>
<th>RISK (%)</th>
<th>SHARPE RATIO</th>
<th>MAX DRAWDOWM</th>
</tr>
</thead>
<tbody>
<tr>
<td>90% Stock/10% Bond</td>
<td>5.33</td>
<td>15.00</td>
<td>0.23</td>
<td>44.23</td>
</tr>
<tr>
<td>82.5% Stock/10% Bond/75% Private RE</td>
<td>5.73</td>
<td>13.79</td>
<td>0.28</td>
<td>42.05</td>
</tr>
<tr>
<td>70% Stock/30% Bond</td>
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<td>11.30</td>
<td>0.33</td>
<td>33.63</td>
</tr>
<tr>
<td>62.5% Stock/30% Bond/75% Private RE</td>
<td>5.85</td>
<td>10.12</td>
<td>0.40</td>
<td>31.37</td>
</tr>
</tbody>
</table>

Sources: PGIM Real Estate, eVestment
Note: Stocks represented by MSCI ACWI; bonds represented by Bloomberg Barclays US Aggregate; private real estate represented by NCREIF ODCE. Portfolios rebalanced annually. Private real estate exposure comes from stock exposure — results similar when exposure comes equally from stock and bonds.

“REITs trade like a stock and are much more volatile than private real estate,” Keating said. “If a private equity fund owns an office building, whatever yield and appreciation that property delivers, that’s what the investor in the fund will receive.”

Value vs. Cost

There is also the matter of cost. Private real estate vehicles are time-intensive to manage and deliver, which makes them relatively expensive compared to traditional assets.

“Here one has to remember that [Employee Retirement Income Security Act] guidelines do not mandate the lowest-cost vehicles available. They simply say that sponsors have to evaluate fees for appropriateness,” said Josh Cohen, managing director for defined contribution at PGIM.

“That means asking whether you are getting a good value relative to the objectives you are trying to achieve,” he said.

Given its potential portfolio diversification benefits, private real estate is one of the most used asset classes across institutional portfolios, and, according to PGIM Real Estate’s Shean, one of the asset classes in highest demand by high-net-worth investors. Yet most American workers cannot get access to this type of investment because they’re not accredited investors. And even if they could, it could cost anywhere from 200 to 600 basis points.

“The value they can get within a DC plan under 100 basis points for this type of investment is really tremendous,” she said. “Why should we just be offering this asset class to the largest institutions and corporate executives, instead of to the average American worker within a DC plan where it can be offered under fiduciary protection and with institutional pricing? I think it’s almost a fairness issue if individual investors are not given the same opportunities to access these types of investments.”

Primer: Daily Valuation of Private Real Estate

It may sound like an oxymoron: Daily valued private equity real estate.

On one hand, private real estate is supposed to be a long-term, low-volatility, illiquid asset that derives its risk premium partially from that illiquidity. On the other hand, highly liquid, daily valued listed real estate (e.g., real estate investment trusts) tends to trade more like stocks, with volatility numbers in the low double digits, nearly triple that of private equity real estate. And for the layman, the general idea of real estate valuation conjures thoughts of squishy, imprecise residential values. Think of comparing one’s own house to sales in the neighborhood and guessing at a ballpark value.

All of which begs the question: How does one preserve the performance characteristics of the illiquid asset in a daily valued liquid vehicle with a credible valuation methodology?

“First of all, these strategies are supported by a huge amount of fiduciary infrastructure that has been built over many decades,” said Mike Keating, senior vice president of portfolio management at Bentall Kennedy. “Second, there is a huge difference between residential real estate and commercial real estate. Commercial real estate — the focus of most private equity real estate managers — has revenue and net operating income associated with it, whereas residential is pure appreciation. With commercial real estate, the income and appreciation together create a total return.”

The valuation model for commercial real estate starts with the income component of the property, i.e., rent rolls for multifamily, office, industrial and retail assets. The manager establishes a value at the beginning of the quarter, based on the rent roll and its associated valuation model, and then extends it out 90 days to create a 90-day accrual schedule. That schedule shows the income coming off the property every day for the quarter.

Managers rely on third-party fiduciaries for the appreciation component of the value. Based on their own modeling, the outside appraisers provide the manager with a forward-looking market appreciation or depreciation over three-months. Liquidity comes from wrapping the illiquid asset with cash and REITs (generally about 10% of the portfolio), which can be used to cover distributions during the quarter.

“So you have both an appreciation schedule and an income schedule,” said Keating. “By parsing out the components of the return over a quarter, you can see very clearly what the property is producing on a daily basis in terms of income and what it could be producing in terms of appreciation or depreciation. There is science behind it, as well as industry best practices, that can create a daily valued liquid vehicle, with very little dilution of the underlying characteristics of the asset.”

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