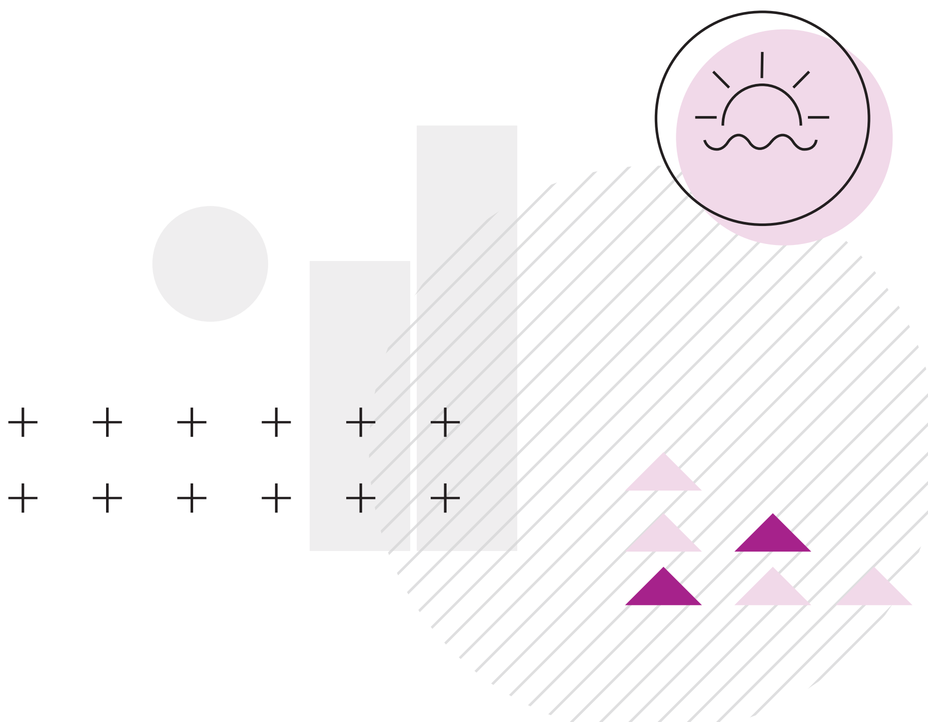
An Employer's Guide to Managed Accounts



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Introduction

Target-date funds have become one of the most popular choices for retirement plans in recent years. They're typically easy for plan sponsors and participants to use. Plus, employers can default their retirement plan participants into such funds when individuals don't actively choose their investments.

But does the popularity and simplicity of target-date funds mean they are an appropriate choice for your plan and its participants?

In recent years, we've seen managed accounts become increasingly available not only as an option in retirement plans, but as the default retirement solution. Their rising popularity stems from the idea that one size doesn't fit all in the retirement industry.

Compared with target-date funds, managed accounts can allow for greater personalization and added potential benefits, but often at a higher cost. If you're not sure whether this service would be appropriate for your participants, this guide will cover some of the basics of managed accounts, evaluate them, and ultimately help you determine whether managed accounts could help your participants better prepare for retirement.

Start With the Basics

Because managed accounts are a less common choice for retirement plans, let's begin by answering a few basic questions.

What is a managed accounts service?
It's a personalized retirement solution that employees can use as an alternative to target-date funds. In addition to tailoring the investment selection based on an employee's retirement date, the service uses investments already available in your retirement plan, and information about each employee, to create and implement a portfolio of investments customized to each employee's needs.

What information does the service use, and where does this information come from?
The solution uses data—such as age, gender, and plan balance—already available through the recordkeeper. Managed accounts can typically yield a significant level of personalization using only the participant data that's already available through the recordkeeper. However, participants may also choose to add supplemental information that may help fine-tune their portfolio.

What does the service do with this data?
The managed accounts service uses available data to help choose investments, determine an appropriate mix of assets (for example, stocks, bonds, etc.), and then monitor and rebalance each account on a continuous basis. So any changes to the account are aligned with the individual's life changes. The service also uses this data to tailor its financial planning and guidance to the participant.

Weighing the Advantages and Shortcomings

Managed accounts can provide benefits and services beyond what a target-date fund can offer. However, managed accounts may not be right for every plan. It's important to understand the advantages and shortcomings of the service.

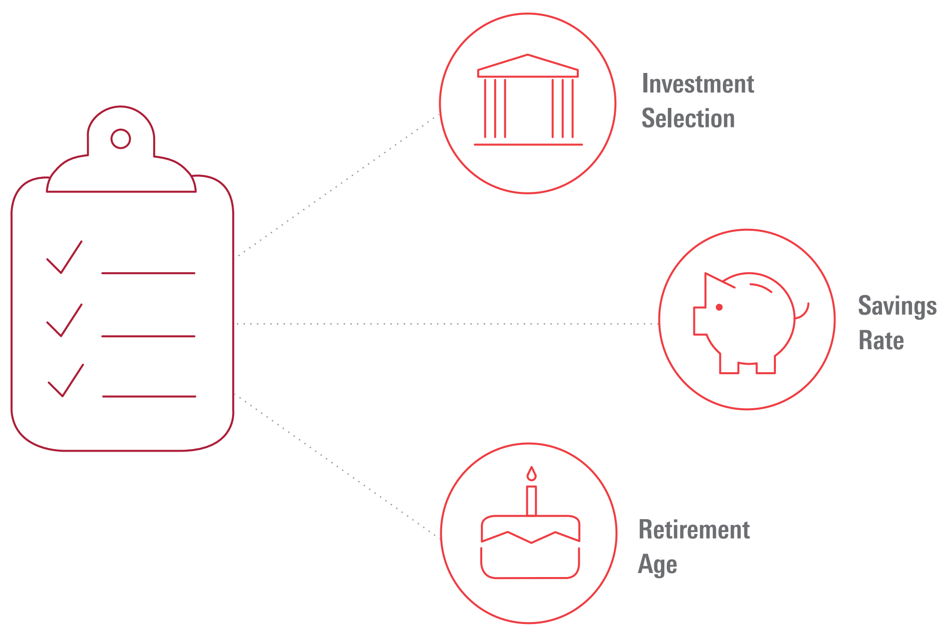
Here's a look at some of the upsides of managed accounts:

Advantage #1: Personalization for Participants

Managed accounts determine an appropriate mix of investments for each participant based on factors beyond retirement age. An individual's circumstances—such as location, gender, and salary—can also be considered. And over time, the service gives participants a chance to share changes that may affect their savings approach. That way, adjustments can be made as needed.

Advantage #2: Holistic Advice

While target-date funds offer generic investment selection based on retirement age, managed accounts use additional data from within the plan and from participants to offer more holistic advice. This includes advice on how much participants should consider saving and when they could potentially retire, which can be key to helping individuals reach their retirement goals.



Advantage #3: Post-Retirement Strategy

Retirement plans can do a good job of helping participants plan and get to retirement, but what happens after? Some managed accounts services provide a strategy for withdrawing money during retirement. This can help participants know exactly how much to dispense annually from each account in a tax-efficient way.[1]

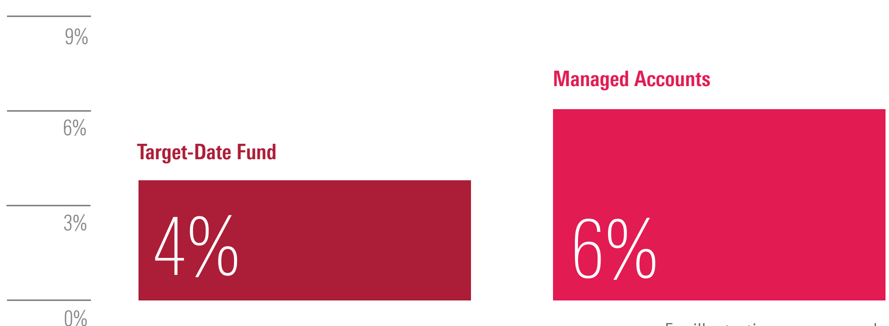
Advantage #4: Employee-Driven Risk Preferences
Let's say two financially similar participants have opposite risk preferences. One is risk-averse, while the other is a risk-taker. Unlike target-date funds, managed accounts can help accommodate them by matching each person to an appropriate mix of assets suited to his or her preferred risk. The managed accounts service can also adjust the portfolio if risk preferences change over time.

Advantage #5: You Can Use Your Plan Lineup
Many managed accounts service providers will analyze your retirement plan's full range of investment options. Then, they will use this information to build portfolios for each individual using the investments you have already carefully selected. The type of service builds on what you have, so there may not be a need to conduct extra research or add additional investments.

Advantage #6: Ongoing Monitoring and Rebalancing
Managed accounts service providers typically monitor and adjust portfolios as a plan's investment selections change. They also rebalance accounts periodically, which is vital to maintain an appropriate mix of assets and keep participants on track.

Advantage #7: Higher Deferral Rates
A recent study from Morningstar Investment Management LLC shows that, even after accounting for age and income, managed accounts have the potential to help employees save more. Individuals who defaulted into managed accounts saved 2% (of their salary) more than those who were defaulted into target-date funds.[2, 3]

MEDIAN DEFFERAL RATE [3]



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Advantage #8: A More Competitive Benefits Package
While approximately 75% of plans are using target-date funds as their default investment option, an increasing number of employers are differentiating their plans by offering a more personalized retirement solution.[2] Differentiation and personalization in employee benefits programs can help attract and retain top talent.

No investment program is perfect. Here are some potential shortcomings to keep in mind when considering a managed accounts service:

Shortcoming #1: Higher Fees

Managed accounts tend to have higher fees compared with target-date funds and with self-selection, in which participants choose their own mix of investments. The average fee for a managed accounts service is around 0.5%.[2] But it's important to know that the higher cost does come with added benefits, such as the potential for employees to save more money for retirement when defaulted into this service instead of a target-date fund. A recent study from Morningstar Investment Management found that the value of the additional savings can be worth up to a 2.4% fee, which is several times higher than the average fee.[4]

Shortcoming #2: Performance Evaluations Can Be Challenging

Managed accounts are not traditional investments. Customized portfolios within a plan make it challenging to compare to a benchmark or other retirement offerings. Target-date funds face a similar issue. Although all target-date funds share the aim of reducing risk over time, they have varying methodologies that also make them difficult to benchmark.[5]

Shortcoming #3: Due Diligence

The due-diligence exercise with managed accounts service providers can be difficult. Recordkeepers only work with and offer services from certain managed accounts providers. Since there are only a few providers currently in the marketplace, it can be challenging to compare one managed accounts provider with another.

Shortcoming #4: Unknown Information

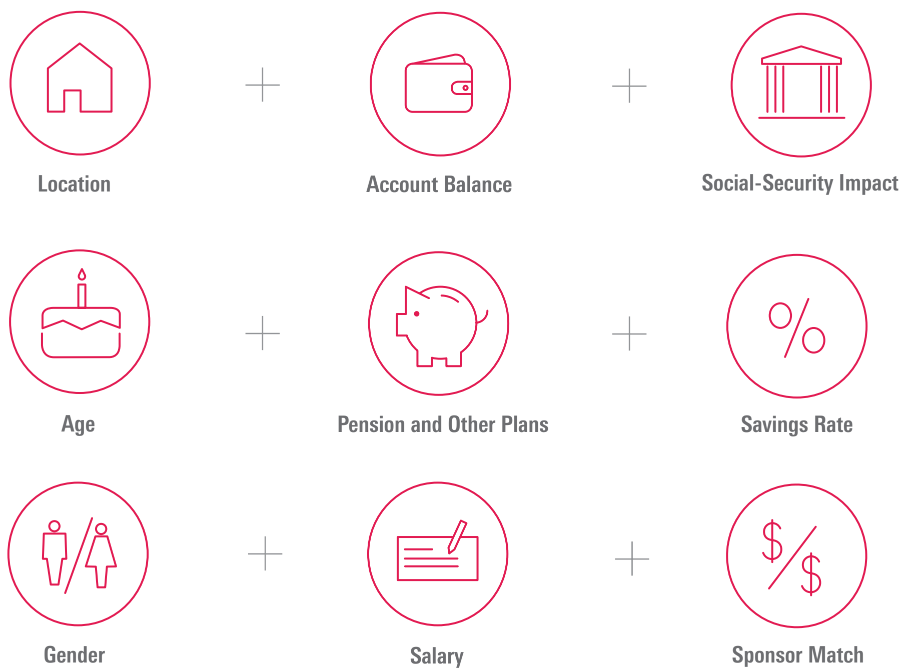
Managed accounts programs can only be as good as the information they receive. Although many managed accounts services have improved in automatically collecting participant information, there is still the possibility of unknown information, or information that the service can't collect from recordkeepers. As participants enter more of their own information, the amount of unknown information decreases and the investment strategy can become more customized.

Some Misconceptions About Managed Accounts

At first glance, the list of shortcomings to the service may seem limited, but a lot of the perceived shortcomings of managed accounts are actually misconceptions.

Misconception #1: Managed accounts only work for older people who have more complex financial situations and lots of assets.
One of the studies from Morningstar Investment Management showed that younger and lower-income participants tended to increase retirement savings rates the most after receiving guidance.[5] Another study that accounted for age showed that individuals who were defaulted into managed accounts saved 2% on average more than those who were defaulted into target-date funds.[2]

Misconception #2: Managed accounts act like target-date funds unless participants take time to submit their personal information.
More data helps, but customization is still possible using data already available through the plan. Off-the-shelf target-date funds only use one data point: age. A managed accounts service takes into consideration more data without participants having to provide it. Many of the data points pictured below are available through the recordkeeper.

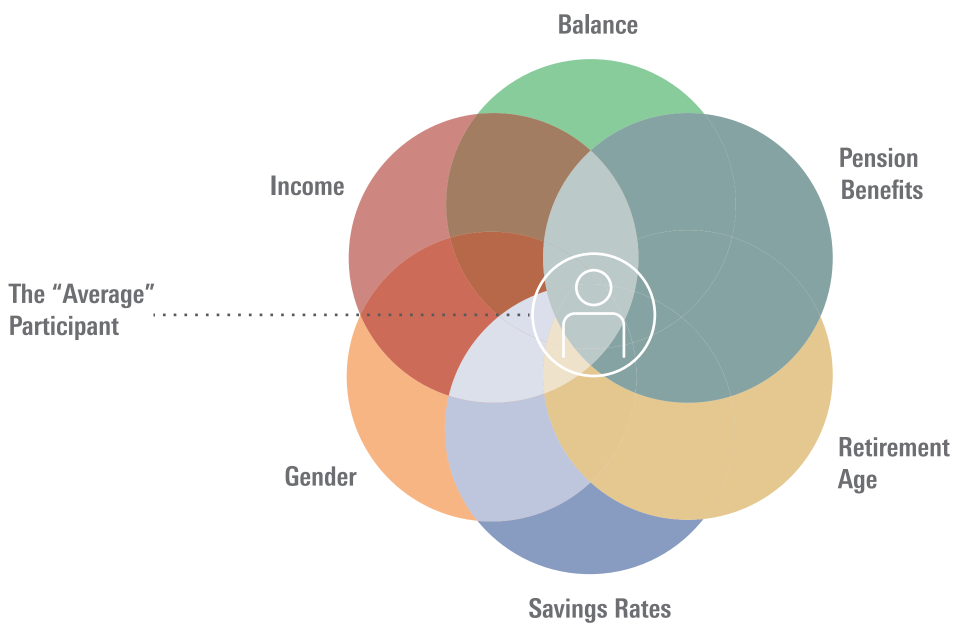


Misconception #3: You must choose to offer either a target-date fund or managed accounts.
With the constant comparisons of target-date funds with managed accounts, it's easy to feel like you must pick one over the other for your plan. Keep in mind that you can offer both options. Participants can be defaulted into target-date funds and have the choice to use managed accounts, or defaulted into managed accounts and have the choice to use a target-date fund. The only thing you can't do is default employees into both options at the same time.

Why Would You Use a Managed Accounts Service?

Now that we've covered the basics of a managed accounts service, let's talk about why you might consider using one, or any other customized solution, in your plan.

People don't walk into their doctor's office and expect their doctor to give them the same treatment as everyone else their age. They probably don't expect that from their retirement plan either. Off-the-shelf target-date funds are built with the average participant of a certain age in mind. But who is the average participant?



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In short, no one. This means off-the-shelf target-date funds may not be the best fit for many participants in a plan. And many who use them may later find themselves short of reaching their retirement goals. It's important to know that age shouldn't be the only factor in determining your participants' retirement investments. A managed accounts service is designed to incorporate more data to help all—not just some—participants.

How to Use a Managed Accounts Service

Managed accounts can be the primary investment for most of your plan participants, or the service can be an additional option. The service could even be combined with another QDIA, or qualified default investment alternative. A QDIA is an investment option that the U.S. Department of Labor allows employers to default their plan participants into when the participant doesn't actively choose his or her investments.

As a QDIA

A small, but growing, percentage of plans use managed accounts as their QDIA. This means that individuals are automatically placed into the program if they don't choose another option. These plans also give their employees the ability to opt out.

As an Option

Some plans offer target-date funds as their QDIA, but provide managed accounts as an alternative that participants can opt into.

A Dynamic QDIA

Some plans are experimenting with first defaulting participants into target-date funds and then moving them into managed accounts when they pass a certain threshold, such as reaching a certain age or income.

What Should You Look for in a Managed Accounts Service?

If you're looking to add a managed accounts service to your retirement plan, here's a checklist of steps to consider when evaluating and comparing different service providers:

- **Review the Fees and Features**—There will be advisory fees on top of the expenses of the individual investments in each portfolio. Make sure to carefully review the fees and features offered by the provider to assess the costs and benefits.

- **Check Integration with Recordkeepers**—Does your recordkeeper work with the managed accounts provider? The service can't be implemented if it doesn't integrate with your recordkeeper.

- **Examine the Data Used**—What data does the managed accounts service use to determine an optimal portfolio for a participant? Check to make sure that the service can incorporate data beyond gender and retirement age.

- **Assess Quality of Investment Decisions**—Be sure that the managed accounts provider has the experience and qualifications to take on the advisor role, and that it is prepared to act only in the best interest of your participants. You should also understand whether the provider will take on the fiduciary responsibility for your plan.

- **Understand the Investment Process**—The managed accounts provider should be trusted to offer advisory services based on accepted investment theories and principles. If you are the plan sponsor, you or someone on your team should be able to have a basic understanding of the provider's investment process.

- **Find Out the Asset-Allocation Approach**—When you explore the provider's investment process, you should spend some time researching and assessing the provider's asset-allocation methodology. What's their philosophy and experience in categorizing assets to optimize risk or reward based on specific situations and goals? Are they considering human capital, a person's ability to earn and save?

Finding a Good Fit for Your Participants

We've found from our various research studies that the more tailored retirement plans are to the demographics of the workforce, the more likely they are to guide better retirement outcomes. A managed accounts service can provide a high level of personalization designed to help each individual employee—not just the average employee—reach his or her retirement goal.

If you think your participants could potentially benefit from a more personalized solution, you can contact us for a custom analysis of your workforce—at no cost to you. Through this analysis, we can help you determine if managed accounts, or another custom solution, might be an appropriate fit for your participants.

References

[1] Participants should consult a tax and/or financial professional for advice specific to their individual circumstances.

[2] Blanchett, David, Dan Bruns, and Nathan Voris. 2016. "The Impact of the Default Investment Decision on Participant Deferral Rates: Managed Accounts vs. Target-Date Funds." White Paper. https://www.morningstar.com/content/dam/marketing/shared/research/foundational/771153-ImpactDefaultDeferral.pdf

[3] Morningstar Investment Management LLC used data from Charles Schwab for 195 retirement plans covering 66,297 participants and analyzed those participants who were defaulted into either a managed account (65 plans covering 17,950 participants) or target-date fund option (130 plans covering 48,347 participants) that had specific plan- and participant-level data available.

[4] For purposes of this analysis, Morningstar Investment Management LLC assumed the participant was 45 years old, did not roll over a previous retirement plan account balance into his or her current defined-contribution account, and stayed in the defined-contribution plan for five years. The participant had an average salary over the test period of approximately $54,000 and an average total savings rate of approximately 8%. The analysis assumes monthly contributions and a portfolio real return of 4%. It was determined that a managed account annual fee of 2.4% would equalize the account balance of the average participant in a managed account option to one in a target-date fund option after five years. Participants with smaller account balances would likely see the most benefit from a program to improve participant savings rates in defined-contribution plans, while participants with higher account balances would need to increase their savings rates by a larger percentage in order to offset the cost of a managed account solution. For example, the same 45-year-old participant described above who had added a rollover balance equal to their current salary to their current retirement account would likely need to increase their savings rate between 0.5% to 1.0% in order to offset the cost of a typical managed account solution. The same participant who had added a rollover balance of five times their current salary would likely need to increase their savings rate by over 2% to offset the cost of a managed accounts solution.

[5] Blanchett, David. 2014. "The Impact of Expert Guidance on Participant Savings and Investment Behaviors." White Paper. https://www.morningstar.com/content/dam/marketing/shared/research/foundational/700098_ExpertGuidance.pdf?

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