Managed Accounts

Buyers guide for plan sponsors of defined contribution retirement plans.

By Constantine Mulligan

This guide is Module 5 of PSCA's Plan Sponsor Tool(k)it and provided as a resource by Constantine Mulligan from PSCA's Investment Committee. The Tool(k)it includes 4 other modules provided by PSCA committees including:

1. Tops and Tools for Conducting a Vendor Search
2. Plan Advisor Search Tool
3. Environmental, Social, & Governance Fund Resource Guide, and
4. Helping Plan Participants Help Themselves: Withdrawal Strategies in a Self-Serve World.

Purpose of this Buyer's Guide

This guide is meant to serve as a resource for plan sponsors who are considering the adoption of a managed account ("MA") solution in their retirement plan. MAs are gaining popularity in the defined contribution retirement plan space, both in terms of utilization, and product offerings. They are being marketed from many different channels, including recordkeepers, third party administrators, and investment managers.

Given the complexity of MAs, and the various implications that their adoption can have on participant retirement outcomes, we've published this guide to help plan sponsors navigate the process around analyzing MAs and deciding whether or not they might be an appropriate solution for their plan. We've arranged this guide in an easy-to-read, question-and-answer style format, with the objective of answering the following five questions:

1. **What are Managed Accounts?**
2. **Are Managed Accounts Commonly Used?**
3. **What Value Do Managed Accounts Provide?**
4. **How Should a Plan Sponsor Decide Whether or Not to Use a Managed Account?**
5. **How Should a Plan Sponsor Evaluate a Managed Account Product?**

Question 1: What are Managed Accounts?

A MA is a professionally-managed diversified investment portfolio that is offered to participants in a defined contribution retirement plan. It is typically offered as a single investment option for an individual's entire portfolio, making it an easy to use "one stop shop" investment solution for retirement plan participants.

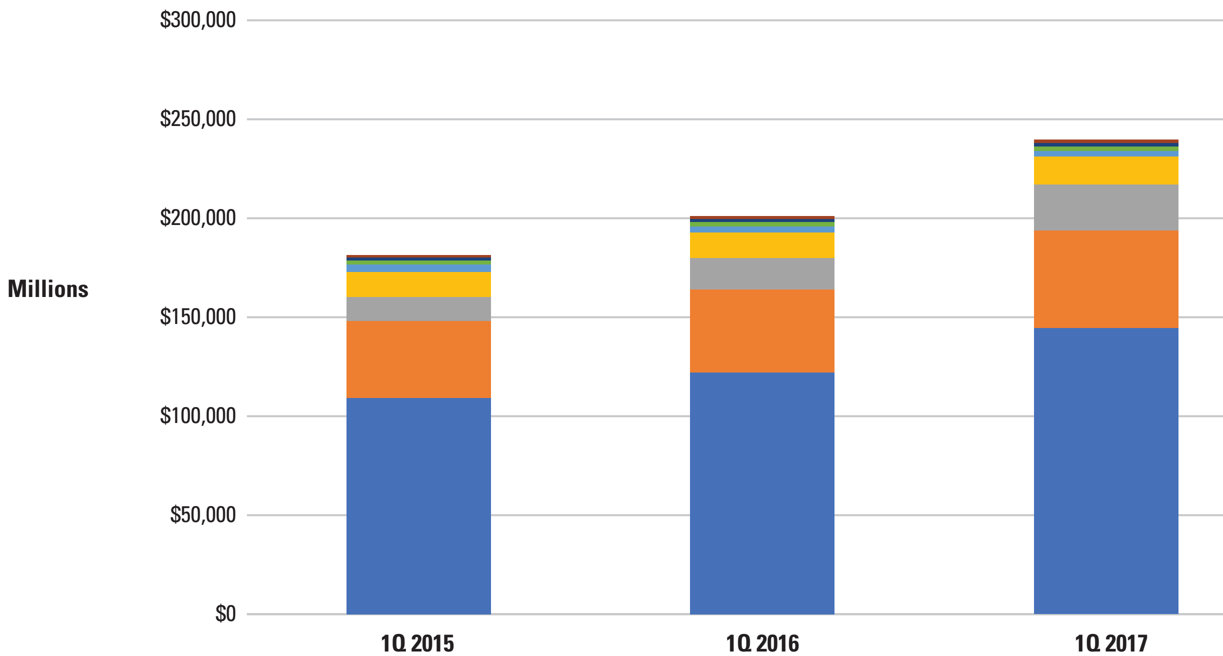
Using technology, a MA combines traditional investment management techniques with financial planning methods to arrive at a custom-built portfolio that is tailored to meet the specific needs of the individual participant. This is unique from other diversified portfolio options in retirement plans, such as target risk or target date funds, because it is designed to be specific for the individual participant, with consideration to their risk and return preferences, unique objectives, and a more complete financial profile. This portfolio is usually constructed using the funds found in the retirement plan menu. Often times, MA solutions also offer participant-level advice solutions, such as financial planning tools or live call centers where they can receive personalized advice about savings rates, Roth vs pre-tax deferrals, Social Security, withdrawal strategies, and other retirement income strategies.

That said, MAs often come with elevated costs, because there is usually a management fee charged by the MA provider, in addition to the underlying cost of the investments used. They also rely heavily on participant engagement to get the relevant data needed to be effective.

Question 2: Are Managed Accounts Commonly Used?

MAs are not new to the retirement plan marketplace. The first solutions that offered specific portfolio advice to participants began gaining popularity in late 1990s, and were offered as online tools that participants could access voluntarily. While these online services were popularly offered, they were not widely used by participants, and

Exhibit 1: Top Managed Account Providers



	1Q 2015	1Q 2016	1Q 2017
Standard	$1,366	$1,396	$1,655
Brinker Capital	$1,535	$1,651	$1,847
ProManage	$2,182	$2,178	$2,330
Stadion Money Management	$3,798	$2,972	$2,679
GuidedChoice	$12,384	$12,896	$14,093
Fidelity PAS-W	$12,323	$15,995	$23,199
Morningstar Retirement Advice	$38,700	$41,900	$49,500
Financial Engines	$109,200	$122,000	$144,400

Millions

were found to be ineffective in helping participants build better portfolios. Later, in the early 2000s, the solutions that we're discussing in this guide were born. One of the first MAs, "Financial Engines," was launched in 2004 and is now the largest provider of such solutions. MAs have gained in popularity since their inception, particularly since 2006 when the passage of the Pension Protection Act established them as one of three, long-term qualified default investment alternatives ("QDIA"). While they are not currently the most popular QDIA (that title would be held by target date funds) they have grown to an asset base of about $240 billion as of early 2017 as the chart below illustrates (Cerulli Associates), which represents about 4.5% of all 401k plan assets (Investment Company Institute, n.d.). Additionally, about 1 in 4 plans offer a managed account solution with approximately 1 in 12 plans using it as their QDIA. However, despite these figures, only about 4% of participants utilize a MA solution (Vanguard, 2017) (Iacurci, 2018).

As you can see from the data in Exhibit 1, assets invested in MAs have increased at approximately a 15% compounded annual growth rate since 2015 and the data suggests that the growth rate is accelerating. Today, there are only a handful of "major players" in the space, but the number of new solutions is expected to grow, and they're being offered by a combination of both investment advisors and recordkeepers.

The provider landscape has caused some sponsors to wonder/question whether or not there are inherent conflicts of interest for MA solutions offered by firms that also provide recordkeeping solutions, or when the recordkeeper and MA provider have a financial arrangement when offering the solution. The perception is that a recordkeeper may be incented to cross-sell these solutions to increase profitability and subsidize narrow profit margins for recordkeeping (i.e., use recordkeeping services as a "loss leader"). Additionally, many recordkeepers are highly selective in which MA solutions they'll allow on their platform and for varying plan sizes.

While the number of plans offering managed accounts has grown over the years, and the assets in MAs has grown in tandem with them, participant utilization is still very low. Indeed, low participant utilization is often the argument cited against the adoption of a MA solution.

Question 3: What Value Do Managed Accounts Provide?

Deciding whether or not to use a MA in a retirement plan comes down to assessing whether or not it will add value. For the sake of this discussion, we'll define value as an aggregate measure of all elements of the solution that improve a participant's retirement readiness, *net of fees*. We'll further define value as a plan-level metric, i.e., the aggregate of all participant benefits must outweigh the total participant cost in order for the MA to demonstrate/show value.

We'll also state that a MA adds value in two ways; First, by building a "better" investment portfolio via asset allocation and portfolio construction, and second, by driving better retirement outcomes by influencing participant behavior through education, interaction, and providing tools the necessary to make better informed decisions.

Asset Allocation and Portfolio Construction

Having a custom asset allocation that suits your personal needs can add value. The value added from this function for those individuals who build their own portfolios is often greater than it would be for those participants who are already using a professionally-managed solutions such as target date funds. We make this distinction because sponsors should view the potential value-add from a MA through the lens of "what other options are available?" With the growing usage of QDIA options, fewer participants are building their own portfolios, and hence the value derived from MAs at the plan level may be diminished.

Research estimates that the value added from personalized asset allocation for those participants building their own portfolios ranges from 0.2% to 0.6% on an annualized basis over the working life investment horizon. This range of value drops, to 0% to 0.5% for those using professionally-managed solutions, e.g., Target Date Funds (Blanchett & Kaplan, The Value of a Gamma-Efficient Portfolio, 2017) (Idzorek, Blanchett, & Bruns, 2018).

However, this potential value-add is contingent upon the ability to capture the data needed, and the methodology used for building and personalizing the portfolio. The common inputs needed for an optimal asset allocation come from an understanding of items such as time horizon, risk profile, return and income needs, total portfolio assets (outside of the plan) and other unique circumstances (e.g., contribution rate, gender, salary, access to other income sources, or concentration in certain asset or investment types). These inputs may come directly from the record-keeping platform through a data feed, but a significant portion of these inputs must often come from the participant. This means that the participant needs to be highly engaged or else the needed inputs may be incomplete or inaccurate. Additionally, the derivation of the information is important. For example, some MA providers rely on risk questionnaires to asses an individual's *preference* for risk, while other providers use quantitative tools to assess the individual's *ability* to take risk. These two perspectives often lead to significantly different asset allocations.

Finally, in the assessment of whether or not a MA adds value from a portfolio perspective, we need to understand how the asset allocation is implemented. The selection of which asset classes to use, as well as which investment managers to use, can play a significant role in the efficacy of the MA. In most cases, the portfolio built for the MA utilizes the investments in the retirement plan menu, and that's not normally a function the MA provider is involved in, i.e., they normally pick from the existing core menu of options. Additionally, for plans that offer company stock or more unique asset classes such as stable value, the task of implementation can be further challenged. The ability to manage within these parameters, or to use investments that are not part of the investment menu, can help add value to the portfolio construction process.

Improving Financial Behavior

The second, more nebulous way that a MA solution can add value is through its ability to influence participants towards better behavior. For MA solutions that include advice-related services, this benefit can manifest itself through improved savings rates, tax optimization, retirement income strategies, and avoiding "bad investment behavior," such as pulling out of the markets at the wrong time.

It is estimated that the value-added from this component can range from 0.50% to 2.35% of excess return on an annual basis for participants depending on their age, and level of engagement — i.e., their willingness to use the tools and advice offered to them (Cosmano, 2018). This is a wide range of potential value, so it's important to examine the drivers of value on a more granular basis:

- **Savings Rate Advice** — the ability to influence participants to save at the appropriate level (typically to save more) is arguably the most important value-add a MA can have. An MA is able to provide this tailored rate of savings because of the information that they're able to gather about the participant, including age, gender, current salary, etc. It's estimated that this can add as much as 0.80% additional annual return across all participant age cohorts (Cosmano, 2018).

- **Decumulation and Income Advice** — the ability to inform participants who are nearing or at retirement with regards to the best way to generate income, and to draw down from their portfolio (including social security claiming advice and annuity usage optimization) can be a large value-add. This value-add, in aggregate, was estimated to range from 0.76% to 1.52% depending on age and level of engagement by the participant (Cosmano, 2018) (Blanchett & Kaplan, Alpha, Beta, and Now...Gamma, 2013).
- **"Stay the Course" Advice** — the ability to reinforce good investor behavior in times of market stress can also add value in terms of improving participant retirement outcomes. This value- add is estimated somewhere in the 0.20% to 0.60% range depending on age and level of engagement by the participant (Cosmano, 2018).

While rolling up the aggregate value of this component of a MA is difficult at best and impossible at worst, it's a fair statement to say that if the advice-related components of a MA product are comprehensive (e.g., website, call center, online tools, in-person participant education meetings, etc.) and if the participant base is highly engaged, the adoption of the MA solution is likely to offer a positive value to the plan as a whole.

Question 4: How Should a Plan Sponsor Decide Whether or Not to Use a Managed Account?

Again, deciding whether or not to use a MA should center around the value added, with an emphasis on value being defined as net of total fees. However, arriving at the value is not clear cut, and even if a value is assessed, the sponsor faces the additional burden of deciding whether it should be used as the QDIA, or as an elective option for participants to choose.

The approaches for assessing the value of a MA range from simple (qualitative question-based assessments) to complex (data-heavy participant demographic study, and utility based value-added metrics). A combination of the two, i.e., "somewhere in the middle" is most likely adequate, but regardless of the method for collecting data and assessing value, the questions that need to be answered are the same. We provide four questions below as a simple, comprehensive way to begin, and further, we suggest a simple binomial decision tree as a framework for arriving at a decision for usage and implementation.

A. What is my hurdle rate?

What is the total cost for the MA solution? Typically, these solutions cost between 0.20 percent and 0.60 percent when you consider the fees for implementation, any asset based charges, and any per-participant fees. This cost does not include the cost of the underlying investments, which can be highly disparate and dependent on factors not always controlled by the MA provider. This all-in cost is the base value of benefit that the participant base will need to realize in order to make the MA worth using, i.e., "clearing the hurdle".

Understanding what this cost is, relative to other QDIA options, will help inform the decision of whether or not the MA should be used as a QDIA. For example, the cost of the underlying investment strategies being used in the MA may be an added expense relative to an alternative QDIA. In theory, if the value gained from using a MA is larger than the fee delta from the MA and an alternate QDIA, then a MA should be considered for use as the QDIA.

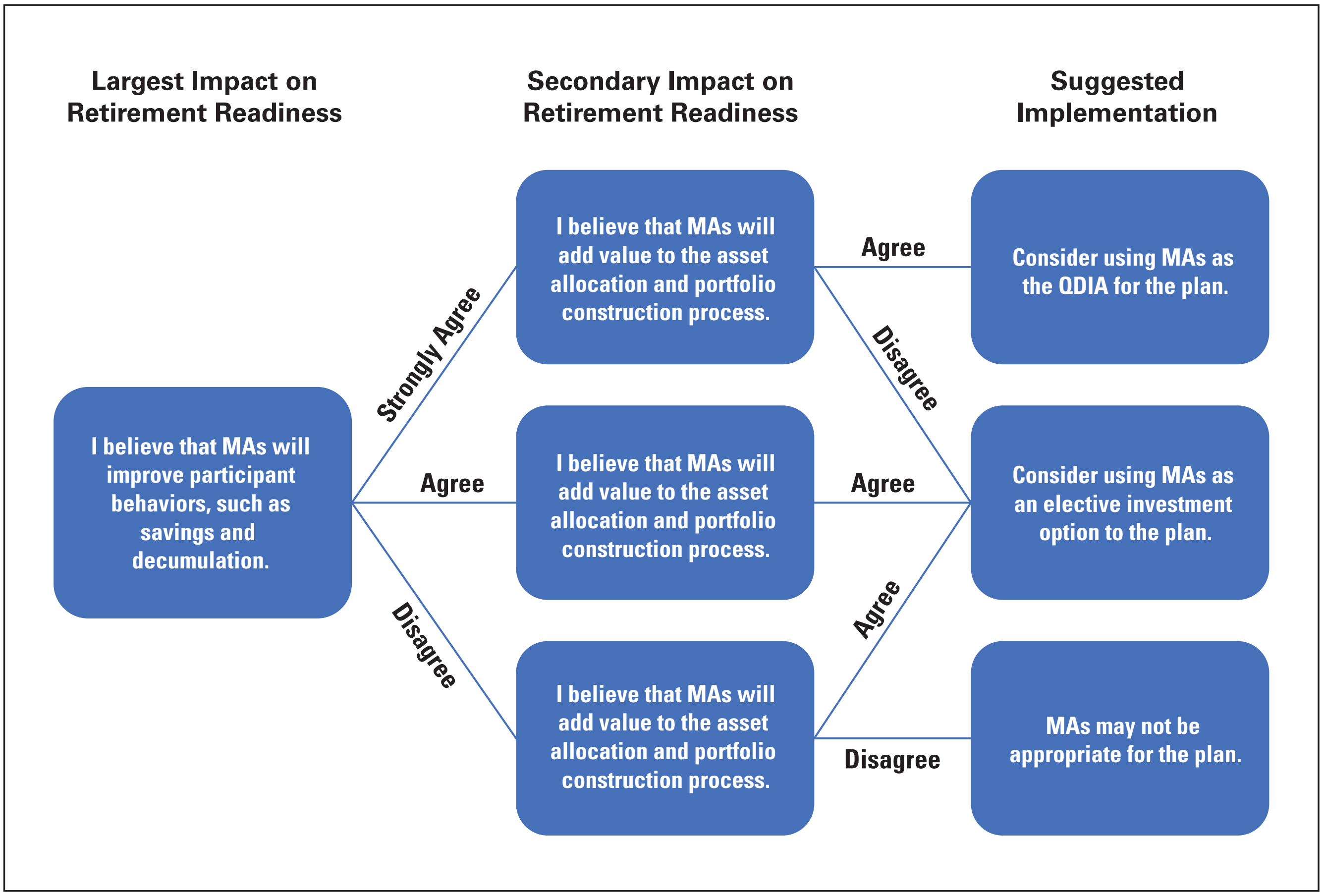
B. Will the MA portfolio solution add value, and how much?

As discussed earlier, a customized portfolio may add value. However, this value is contingent on having the proper level of participant engagement, the proper and accurate data about the participant base, the provider's methodology for building asset allocation, and the provider's access to the proper mix of investments to implement the asset allocation. If a sponsor can assess that the data on participants is accurate, complete, and will come from a combination of the recordkeeper and the participant, that the provider's methodology can add value, and that the provider's investment "needs" can be met by the investment offered, then this component of the MA may add value. The estimate on that value, as mentioned earlier, may be as high as 0.6 percent as an "add on" elective solution (for those folks who are building their own portfolios) and maybe as high as 0.5 percent as an alternative for the QDIA.

C. Will the MA improve participant behavior, and how much value can that add?

Will the MA improve participant behavior, particularly with regards to savings and decumulation strategies? This ability to add value is highly contingent on participant engagement and participant need (e.g., if participants are already displaying optimal behavior, there may be no need for a MA). If a participant is not fully using the services provided, they will not realize the full benefit. For example, participants who opt into the solution may get the portfolio benefits described above (or at least in part) but if they aren't using the savings-related advice, they may not increase their savings to an appropriate level. Similarly, if participants are not utilizing decumulation advice, such as Social Security claiming techniques or creating and implement-

Exhibit 2: Managed Account Decision Tree



ing custom withdrawal strategies, they will miss out on another major source of value-add.

If the sponsor can assess that the level of engagement is high, and that participants need help with their behavior, particularly with regards to saving and decumulation, then they should consider implementing a MA.

D. Should I implement a MA solution, and how?

This decision boils down to the level of value added for a participant base. We suggest that if the benefits of a custom portfolio coupled with improved investment behavior outweigh the "hurdle rate" described in Question A, the sponsor should use a MA in some fashion. If the value added is small, then perhaps the MA should be added as an elective option (i.e., the participant can opt-in to the decision) and if the value added is large than perhaps the MA should be used as the QDIA (i.e., participants who do not elect otherwise are automatically defaulted into the MA).

Our decision tree (see Exhibit 2) begins by determining the degree to which a sponsor can assess the MA's ability to drive better investment behavior. Given that this component has been shown to be the largest value-add a MA can have, if a sponsor can assess that the full value of that component will be realized (through engagement, utilization of advice, changing of savings rates, etc.) then the decision will most likely lead to some form of implementation. The second step is assessing whether the asset allocation and portfolio construction methodologies will add value. If so, the chances are that some type of implementation will be higher.

5. How Should a Plan Sponsor Evaluate a Managed Account Product?

Once a sponsor has decided that a managed account solution makes sense for the plan, the final step is selecting the right one. Often, the selection process starts with understanding what MA solutions are available on their recordkeeping platform. Because of the data integrations needed between the recordkeeper and the MA (and more cynically, because of the competitive compensatory arrangements of these products), they are often not universally available across recordkeeping platforms.

However, once a "short list" of available products has been established, a deeper due diligence dive is necessary. A sample request for information or "RFI" can be found at the end of this guide, and it serves as a resource to effectively gather information for analysis. We'd recommend sending this RFI, supplemented with any other relevant questions, to all providers on your short list and compiling the data in a matrix-like format for comparison.

The focus of the due diligence should be to gain a deep understanding of the product and to be able to compare alternatives to understand which components of each product are likely to add value for participants. A general breakdown of the evaluation criteria can be found below:

General Product Information

- History and tenure of the product.
- How widely utilized is the product?
- Restrictions on use, e.g., investment minimums.
- Portability to other recordkeepers.
- What does the implementation process look like?

Who are the People?

- Who are the managers of the product?
- Why and how are the managers qualified to manage?
- Is the firm willing to act in a full fiduciary capacity?

What is the Investment Philosophy and Process?

- How does the MA provider build asset allocations? What is the methodology attempting to optimize for/against. What is the goal?
- What investment strategies/asset classes are needed vs. preferred to build a portfolio?
- How often are portfolio allocations reassessed? Rebalanced?

What are the Services?

- What services are offered to participants for portfolio building?
- Is there a website for financial advice and retirement savings tools?
- Is there a live advice component — i.e., a way for participants to talk to a fiduciary advisor?
- Will the MA provider do participant meetings?
- Are customized communications included?

What are the Fees?

- What are the all-in fees?
- Is there an asset-based fee for the MA?
- Is there a per-participant fee for the MA?
- Is there a plan-level implementation fee?
- What is the compensation arrangement between the MA provider and the recordkeeper?

Summary and Conclusion

A MA is a professionally managed, diversified investment portfolio that is offered to participants in a defined contribution retirement plan. The services offered with a MA often combine portfolio construction and financial planning to deliver a comprehensive solution, tailored to a specific participant's needs.

While MAs are not common in use amongst plan sponsors, they are gaining in popularity as the number of providers grow, and as implementation and integration issues lessen with advancing technology. Understanding what lines of business the MA provider is in, along with compensation agreements they may have with recordkeepers and other vendors, can help sponsors navigate conflicts of interest.

As a sponsor, providing a MA solution to participants may add value in the form of a customized portfolio, as well as through advice-related services offered by the MA. Research suggests that the estimated value of using a MA (expressed as an annualized return) can range from zero to well over 2% a year, relative to alternative solutions.

However, understanding the all-in cost of a MA product will help inform the decision of whether or not the MA should be used in a plan, either as an elective option or as the QDIA. In theory, if the plan-level value gained from using a MA is greater than zero, adoption of a MA is likely in some manner.

Finally, if a plan sponsor decides to add a MA to their plan, comprehensive due diligence is needed on the specific solutions that are available on the plan's recordkeeping platform. A sample request for information (RFI) is available in the Plan Sponsor Tool(k)it at https://www.psca.org/PS_toolkit, and it serves as a resource to effectively gather information for analysis and comparison.

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