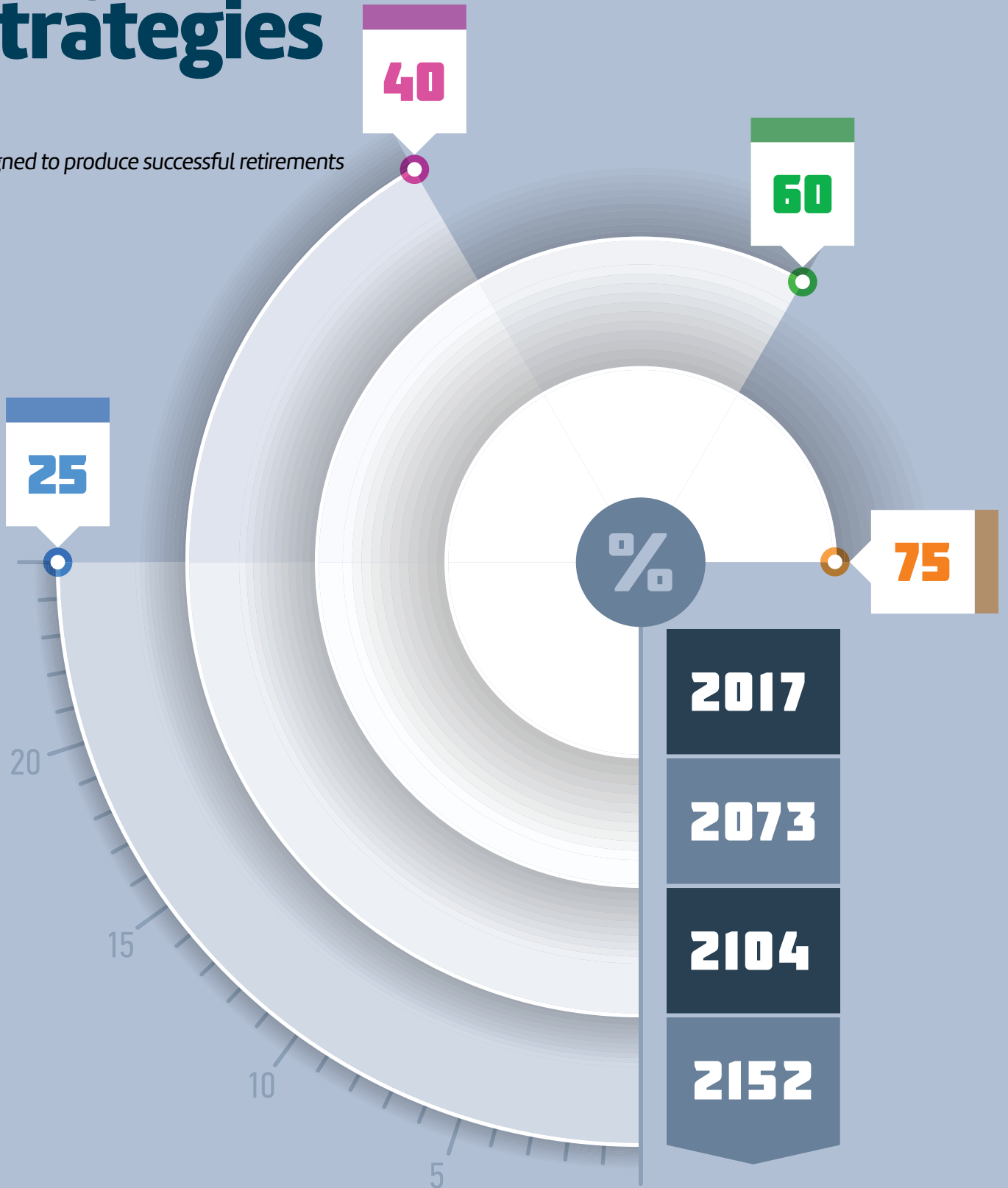


Custom Target-Date Strategies

Designed to produce successful retirements





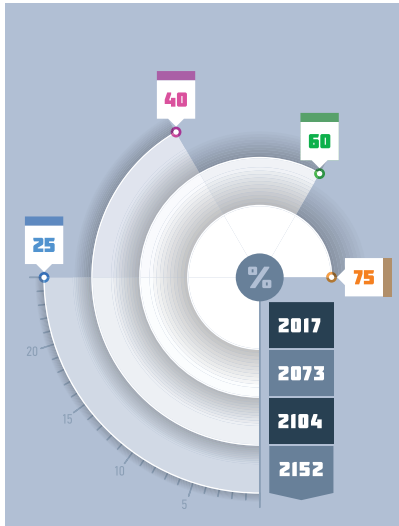
Even a well designed default can weaken over time.

Today's default options are built better than those from just a few years ago. If you don't keep your default current, it can jeopardize participant outcomes and create a potential liability for you as a fiduciary.

At AllianceBernstein, we can help you design a default that can bolster your DC plan. A default built to evolve with changing market and regulatory conditions, as well as employee needs. You'll also be able to seamlessly select and replace managers. And give participants the confidence that their plan will remain up to date in the future.

Don't let inertia increase your fiduciary risk. Make your default option the strongest link in your DC plan. After all, no one wants to have an outdated default hanging over their head. To learn more, visit us at abdc.com.


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The Maturing of Custom Target-Date Funds



Maybe it was the Department of Labor's tips, released last year, that prompted renewed interest in custom target-date funds. Maybe it's just the number of years since many plans started using target-date funds as qualified default investment alternatives (QDIAs). Whatever the reason, 2014 is turning out to be a banner year for custom.

"I'm hearing more about customization this year than in any other year," says Glenn Dial, Managing Director and Head of U.S. Retirement Strategy at Allianz Global Investors. "The target-date industry is maturing; plans are getting larger and plan sponsors want more certain outcomes for their unique participants. This often leads to conversations about custom solutions that align with their plan's actual needs."

Defined contribution plans are becoming bigger by the day, thanks to the demise of the defined benefit plan and the concerted efforts of plan sponsors to nudge participants to higher levels of savings. That growth in assets produces its own pressure points. One of those is necessarily on the target-date fund, particularly if, as is likely, it is the QDIA.

"There's an alarm clock in most plans that will go off in a few years, when the majority of plan assets are in target-date," says James Sia, Head of Defined Contribution at GMO. "The market share of target-date assets is about 15% across the DC market broadly; in any one plan, then, an average of 15% of plan assets are in target-date funds. With auto-enrollment and auto-escalation, target-date funds are capturing 75% to 85% of the cash-flow share. So the percentage of assets in target-date funds will continue to grow. Once the asset level passes 50%, it raises the question of whether the plan sponsor wants to have all these assets managed by a single manager. It is something a DB plan sponsor or an endowment would never do. And, it is the reason the DC market moved to open architecture 25 years ago."

Keeping control

This hurdle is fast approaching for some plans. "As target-date funds become 50%, 60%, 70%, even 80% of plan assets – as we believe they will – are you ever going to put all those assets

with a single manager?" asks Richard Davies, Senior Managing Director and Co-Head of North American Institutions at AllianceBernstein. "For those that are deferring the decision to use open architecture, I would ask them to think about whether any single manager could be good in everything, no matter how big they are."

This question of control crops up often in conversations around target-date funds, as does the question of what works for a small pool of target-date assets not working for a larger one. "Target-date funds are becoming the most important investment option for most plans, given default investing, and auto- and re-enrollments," says Josh Cohen, Managing Director, Head of Institutional Defined Contribution at Russell Investments. "Plan sponsors are saying, 'We don't want to cede control of all aspects of that option to one provider, whether it's the managers underneath the asset classes, the mix of active and passive, or the glidepath.' When you go off-the-shelf, all of those decisions are determined by a single organization. Some plan sponsors want to have more control over various aspects of decision-making, if they have both the scale and the appropriate capabilities, so they go custom."

The move to custom isn't a simple exercise, and it's sending plan sponsors back to basics, asking what is the objective of the target-date fund. "We think that investing for retirement is about accumulating enough wealth to support the consumption you want to make in retirement," says Ben Inker, Co-Head of Asset Allocation at GMO. "Our base case is that you need wealth sufficient to support spending of 50% of final salary in real terms in retirement, assuming that you get an additional 30% from Social Security. So we think the right way to put together a target-date portfolio is to solve the basic retirement problem."

"Understanding the target income replacement ratio of the DC plan is one of the most important factors for determining the type of glidepath a plan sponsor considers," says Allianz Global Investors' Dial. "And it's important to realize that factors such as Social Security assumptions, access to other benefit plans and average participant income may impact the targeted retirement income replacement ratio."



As more assets flow into this popular DC choice, plan sponsors are reviewing their glidepaths, strategic asset allocation and interestingly looking at individualization

Solving for the right income replacement ratio is fast becoming the basic aim of many target-date funds. “It depends on what you are trying to achieve in your target-date program,” says Paul Zemsky, Chief Investment Officer of Multi-Asset Strategies and Solutions at Voya Investment Management. “Some are trying to achieve the highest wealth in the account, which is a noble effort. But we would argue that what you want is the highest income replacement ratio. Building the highest wealth is not a complete answer. If someone has a \$500,000 balance and they are making \$50,000 per year, that’s a pretty good wealth-to-income ratio and will give a good income replacement ratio in retirement. If someone is making \$250,000 a year and they have only accumulated \$500,000, that’s not enough to retain their lifestyle in retirement.”

The solution can be simple in principle, but as this example shows, complicated in execution. Not all plans are the same and not all participants in a given plan are similar. “Target-date funds are not meant for the entire participant base. They’re for the delegators, who are often defaulted into the QDIA, which is generally about 90% of participants,” says Allianz Global Investors’ Dial. “The sophisticated, do-it-yourself investors aren’t necessarily going to take advantage of the target-date funds.”

Expense ratios

“Plan sponsors are looking at more thoughtful plan objectives than maximizing return per unit of risk,” says GMO’s Sia. “These include minimizing expected shortfall risk and evaluation of target-date funds against percentage of replacement income achieved and how smoothly this is delivered. This idea is akin to tracking funded status in a DB plan. The components of the plan will be evaluated on a volatility of funded status.”

For those thinking about custom, it probably makes sense to work through all the alternatives. “The main reasons that plan sponsors are moving away from traditional mutual funds these days are to customize their glidepath and expense ratio,” says Allianz Global Investors’ Dial. “That’s what we call ‘basic’ custom. If a plan sponsor is looking for a glidepath that

aligns with their participant demographics and are targeting a specific expense ratio, then we’d suggest considering the roughly 40 ‘off-the-shelf’ glidepaths out there, before going down the custom route. The first step would be to check out the existing pre-packaged funds before going with a ‘basic’ custom solution.”

All that said, it helps to focus on those participants that will be most likely to use the option. Custom is most attractive to those plans that have a particular demographic. “Most off-the-shelf plans are built for the average person,” says Voya’s Zemsky. “This can be the average person on the recordkeeping platform or the average employee based on national data. So when you go custom you could start to customize the solution to your particular employee demographics.”

“One reason to consider custom is if the participant population differs significantly,” says GMO’s Inker. “Some companies have a significant DB legacy plan that changes the needs of its employees. In some companies, people tend to retire earlier or later, or have a very different income than the standard assumptions. All these elements lead to different optimal portfolios, and off-the-shelf products can’t meet those needs. Custom also allows you to find the best-of-breed solutions to the individual pieces, which can generate additional return for participants.”

It also depends on the attitude of the sponsor. “If the company philosophy is paternalistic and focused on providing their employees with the best retirement preparation possible, then they are a good candidate for choosing custom,” says GMO’s Sia. “Another reason would be a unique plan design, whether it’s a transition from DB to DC, or a population that has a different career pattern such as police or firefighters that retire at 45.”

Probably the reason most cited is the ability to use multiple asset managers. “Custom target-date allows plan sponsors to obtain best-in-class managers for each of the different strategies and the glidepath,” says Julie Stapel, Partner in the Employee Benefits Practice Group at Morgan, Lewis & Bockius. “From a fiduciary point of view, this is helpful because it allows you to show that you’ve taken the

steps to get best-in-class, which you may not be able to show for a pre-packaged product. This modular approach is useful because you can swap out managers of individual strategies without having to replace the entire fund. It’s difficult and time-consuming to replace an entire target-date fund from a due diligence perspective because of the number of moving pieces. It could be a waste of resources to do this if the plan fiduciary was only unhappy with one of the underlying elements.”

Comfort level

Plan sponsors that have or have had a strong defined benefit plan often have the internal resources and expertise to manage the complexities associated with a custom fund. “Companies with a large DB plan have tended to want to use their DB managers in their DC offerings,” says Voya’s Zemsky. “That’s because they’ve spent a lot of time and effort finding these managers, and presumably have some comfort with them and want to include them in their DC offerings, particularly target-date funds. Most off-the-shelf products would not allow plan sponsors to choose their own managers, whereas a custom program could.”

Just having a defined benefit plan doesn’t make the custom choice easy. “The existence of a DB plan has two primary impacts in regards to custom target-date funds. For one, Russell designs target-date funds with a focus on retirement income as the goal, so if there’s a DB plan for some or all of the participants in the population, that can have a significant impact on the retirement income goal,” says Russell’s Cohen. “Sometimes the existence of a DB plan can complicate matters because only some of the participants have it. So it’s a consideration that needs to be worked into designing a glidepath. In addition, those plan sponsors with DB experience are used to thinking about the best-of-breed framework, so it’s likely they would be comfortable with custom. But we also find many large plans that only have DC are going custom too.”

“Companies that come out of a DB heritage are more comfortable with custom target-date,” says AllianceBernstein’s Davies. “But

continues on page 6

the company that chooses custom may have other characteristics. It has a knowledgeable, though not necessarily large, investment staff, so they are not just focused on the administrative aspects of the 401(k) plan, but think about the investments as well. Often they want to harmonize the investment manager lineup and the oversight process between the DB plan, which may be frozen at this point, and the 401(k) plan, which may be bigger than the DB plan and growing more rapidly. The 401(k) plan probably grew up being supervised by (human resources). It may still have retail mutual funds and a very different set of managers in the DC lineup than on the DB side. So there could be value in going custom and using, say, one large cap manager across a consolidated DB/DC manager lineup. It can mean reduced oversight, common investment philosophy and better buying leverage."

Custom isn't the right choice for every plan, often simply as a function of the size of target-date assets. "Plans with over \$100 million in 40 Act target-date funds are the ones that are considering custom options today," says Allianz Global Investors' Dial. "These plan sponsors tend to think that they can get better participant outcomes by going custom."

"Plans that tend to choose custom still tend to be on the larger side, though that is now just slightly above \$100 million," says Voya's Zemsky. "They are often plans that are a bit more sophisticated and have dedicated staff. Once the custom target-date plan is up and running, it's fairly easy to maintain. But setting it up takes time and effort. We still see more inquiries from those companies with DB plans, or those that are trying to figure out how the DB and DC plan interact. But even that trend is diminishing, as we are seeing more DC-only companies considering custom."

Scalable solutions

Smaller plans may also soon be able to get in on the act. "We are seeing plan sponsors looking for solutions that can be scalable for smaller plans," says Russell's Cohen. "This could be implemented through a model portfolio approach, or even managed accounts."

When custom target-date funds were first introduced, some plan sponsors bemoaned the complications of launching these options. Today the process is much easier. "It would be interesting to compare the experience of a custom target-date pioneer with someone implementing a program today," says GMO's Sia. "There's a skill set and level of experience in the industry that wasn't here 10 years ago. So it's easier to do custom today, partly because there are more standards around fees, reporting and implementation. It can be a 12-month process or a multi-year process, depending on the objective of the plan. You can customize the pieces you want and in the order you want."

It may be easier, but it isn't easy. "It has become easier to set up custom target-date pro-

grams as recordkeepers, custodians, managers and consultants have gotten more familiar with them and learned from experience," says Voya's Zemsky. "But there is no escaping the fact that initially, there needs to be a larger time commitment from the plan sponsor."

Custom can offer other advantages. "Some plan sponsors have found that custom solutions can be offered at a lower cost, particularly in cases where a plan might otherwise be in an off-the-shelf product that uses higher-cost funds as the underlying funds," says Morgan, Lewis' Stapel. "Custom isn't always lower cost, but it can be, particularly if the plan sponsor has existing relationships with managers in the DC or DB plan."

Plan sponsors can also make changes to their custom target-date plan if they so wish. "The nice thing about a custom target-date fund is it can evolve over time," says Russell's Cohen. "So as the makeup of your population evolves and you are able to include the primary benefits they are receiving, you can further customize the plan, in addition to being able to add new managers and asset classes over time."

Customization

How custom is custom? It's an exciting question that plan sponsors are asking. The answer from the asset management industry is, it seems, as custom as you like. The biggest development in custom target-date funds is individualization. "We think the biggest change coming is participant-level customization," says Allianz Global Investors' Dial. "It allows true asset-liability management at the participant level, which can lead to more predictable retirement income. The technology exists today. It considers demographic information from the recordkeeping system, individual behavioral tendencies and desired investment strategies. The result is an individualized glidepath that can achieve DB-like results at a lower cost. We are doing it for a large client today."

This move to individualization provides an end-run to the problem of diverse demographics. "We think the future of custom target-date is a structure that looks, legally and operationally, more like a managed account," says Russell's Cohen. "For a default investor, you would take a few more pieces of information that are readily available on the recordkeeping system and provide a custom asset allocation based on that participant's particular situation. You wouldn't then treat every 50-year-old exactly the same."

It also could provide a better solution to the issue of retirement income. "The next generation of custom target-date solutions will contain guarantees and be implemented at the individual level," says AllianceBernstein's Davies. "So the individual will be able to do two things: dial in their own retirement date and choose what percentage of their retirement income they want guaranteed. The problem with man-

aged accounts today is that they are expensive and overbuilt for a default solution. If you could build an individually customized solution that could work as a default at a reasonable price, I think the industry could definitely go in that direction."

"We expect to see more customization at the participant level," says Allianz Global Investors' Dial. "If you can have retirement income incorporated, then you can create mini-DB-like plans, with asset liability management and transition risk management (managing the transition from accumulation to de-cumulation). There are risks plan sponsors need to consider beyond market risk."

The transition to retirement and how to provide income in retirement are issues that continue to perplex plan sponsors and participants. "Retirement income isn't just a product," says Russell's Cohen. "It's a mindset. We've always designed our glidepaths around trying to meet a retirement income goal. Ultimately, putting in guaranteed solutions to help meet that goal will increasingly become more important in QDIA and other DC plan designs. There are still many regulatory, operational and product hurdles to overcome. I do believe that it is probably through a more individualized default option and not necessarily just a target-date fund that guaranteed products will find their way into DC plans. The amount of guaranteed income that a participant needs is very personal based on their individual situation. So just trying to deliver guaranteed income through a target-date fund may not be good enough."

"Solutions that incorporate retirement income will be another driver in industry growth," says Allianz Global Investors' Dial. "Especially when the (Department of Labor) provides an updated safe harbor on in-plan insurance offerings."

Target-date funds are garnering much attention from plan sponsors – and the industry – these days. Not all of this attention may be welcomed. "There has been some speculation that target-date funds may be the next subject of interest for the plaintiffs' bar in ERISA," says Morgan, Lewis' Stapel. "Maybe there will be lawsuits alleging that target-date fund fees are too high, for example. If that comes to pass, depending on the nature of the lawsuits, it may make custom more attractive – or less. The litigation may cut either way, but I might imagine that it would cut in favor of custom if plan sponsors get sued over having off-the-shelf products."

"No one has a crystal ball, but all the preliminary indications are that custom target-date is going to be a big growth area," says Allianz Global Investors' Dial. "More plan sponsors want an option that is better suited to their plan demographics and their plan's goals. But, it's not right for every plan sponsor. The first step is to look at the 40 Act market and see if there's an appropriate fund there. If not, then consider custom." ⇐

Are you overlooking tomorrow's biggest risks?

Learn how to form a transition strategy that shifts your retirement plan's focus from accumulation to income.

Retirement-plan sponsors and advisors know they need to be aware of the many dimensions of risk that plan participants face.

But with the industry's overwhelming focus on asset values at retirement, one key element is frequently going unaddressed: how to effectively manage the transition from accumulation to income.

Encountering unfavorable market conditions at this critical point in time can have a significant impact on retirement income—one that can be even more severe than the effect of falling asset values.

The good news? There are thoughtful approaches available today to help you form an effective transition strategy—and Allianz Global Investors can help. Read our new white paper to learn more.

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Allianz Global Investors White Paper Series
Transition Risk: Rethinking Investing for Retirement
By Tim Frawley, Wolfgang Maier, Ph.D., and David Karm

Executive Summary
An industry of investors, retirement-plan sponsors and financial advisors really focusing on the right retirement goal? This white paper explores the critical but often overlooked dangers generated by transition risk—the risk that investors make the transition from accumulation to income at an unfavorable point in time under unfavorable market conditions. Learn why fluctuating interest rates—the most unpredictable factor in the retirement-income equation—make it imperative to help plan participants shift the focus from asset value at retirement to income at retirement.

Seeing for retirement not only makes some of the most difficult and complex financial decisions that most investors will make in their lifetimes, but it can have one of the most significant impacts on their quality of life. That's why it is so important for retirement-plan sponsors and advisors to be aware of the different dimensions of risk involved in retirement investing so they can help plan participants make the right choices for their individual retirement needs.

An Overwhelming Focus on Asset Value at Retirement
There are several risks that need to be taken into account to help investors make smart retirement choices. Some are widely known, yet often hard to work around even though their impact can be crucial. One of these complex risks—transition risk—is the primary topic of this paper.

The most common interpretation of risk is financial market risk, or the risk that investors could lose money if their asset prices fall. This is a risk that investors can perhaps most avoid of bonds, real estate and other investment products. The steady flow of information keeps investors informed about what their portfolios are worth in terms of dollars, and it gives them attention by being right into their biggest fear: the risk of declining asset values.

This fear is paired to some extent—after all, asset values have a large impact on retirement savings—but it is not the only risk investors should be concerned about. Moreover, the closer plan participants get to retirement, it may not even be the most important risk.

The Need to Shift Focus to Income at Retirement
Understand which risks retirement-focused investors should consider in, we need to ask several important questions:

What are investors saving for? To have money at retirement? Or to have money to retire? Although the difference between the two concepts is just two letters long, it is key.

Because of widespread awareness of financial market risk, there is a widely held belief that it is more important to focus on measuring money at retirement, and therefore that accumulation is important.

Allianz Global Investors, we believe the view is wrong, and that plan sponsors and advisors must help participants shift the focus from asset value at retirement to income at retirement. This is further because that retirement income, in most cases, should be a combination of money from principal and savings generated income stream to meet basic needs and maintain living standards.

Why is this risk so focus on retirement? Because measuring, or using the net asset value of the plan participant's portfolio at retirement is not necessarily equivalent to measuring or securing a retirement income stream. This is where transition risk comes into play.

Why Transition Risk is Important
Transition risk is clearly related to longevity risk—the risk that investors will "outlive" their money. While the demographic trend involving longer life expectancy generally is a positive one, it also increases the danger that investors will run out of money during retirement. It is a risk, not only in regard to the necessary counterbalancing against longevity risk to some degree, but in many cases it will be reduced that they face. This will require prudently planning an anti-qualified income stream—and perhaps even using a certain retirement-income level based on a life expectancy guarantee.

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Why the Glidepath Matters

Asset allocation is the biggest single determinant of success in reaching an investment objective, so it stands to reason that plan sponsors are focused on constructing the best one possible



In target-date land, glidepaths are important. The concept of an asset allocation that changes over time to accommodate the closed-end nature of the retirement savings challenge underpins the entire target-date proposition. So when it comes to custom target-date funds, glidepaths garner plenty of attention, whether or not customizing the glidepath is the rationale for the choice. The professionals acknowledge that this is probably the right attitude.

"The glidepath is the factor that has the biggest influence on the overall success of the program, which is getting a good income replacement ratio," says Paul Zemsky, Chief Investment Officer of Multi-Asset Strategies

and Solutions at Voya Investment Management. "Plan sponsors have to feel comfortable with the philosophy, the approach, the team and the analytics of their glidepath manager before other factors come into play."

It is this emphasis on philosophy that other managers echo. "Within boundaries of good policy, we can build a glidepath that is as conservative or aggressive as the investment committee believes is appropriate," says Richard Davies, Senior Managing Director and Co-Head of North American Institutions at AllianceBernstein. "To me, the issue is less about the demographics of the employee base and more about reflecting the philosophy of the plan committee and what they are trying to achieve."

The issue of demographics isn't simple, though. The profile of the beneficiary group can't just be described through age and earnings statistics. "It's important that the glidepath matches your employee demographics, the goals for the plan and the behavioral patterns of the participants," says Glenn Dial, Managing Director and Head of U.S. Retirement Strategy at Allianz Global Investors. "Decisions are often made based on the financial side without incorporating the behavioral side – the participant's risk tolerance and withdrawal pattern. I think there needs to be an equal weight to both financial and behavioral factors to get the right glidepath."

Incorporating all of these factors most likely

points to a custom solution. “Probably no off-the-shelf glidepath was put together assuming the particular combination of circumstances that your employees have,” says Ben Inker, Co-Head of Asset Allocation at GMO. “They are all trying to solve slightly different problems, none of which are the problem you are trying to solve. It may be, by coincidence, that one is really close to what you need to do. But to know that, you would have had to solve the problem first and then look for the glidepath. And I would say, if you’ve done that work, you’ve built a custom glidepath.”

A custom glidepath can adjust to the needs of the population. “The higher the savings rate, the more conservative the glidepath can be,” says Allianz Global Investors’ Dial. “A common misperception is that if your participants are not saving enough, then the glidepath needs to be more aggressive to try to make up for missed savings. The end result of this philosophy is the tendency to widen the gap between the ‘haves’ and ‘have-nots’ as measured by adequate retirement income.”

Optimal place

So there is need to balance conflicting objectives. “The goal is really maximizing the utility for a participant of an income replacement ratio,” says Voya’s Zemsky. “You can almost always boost the expected income replacement ratio, say 40 years from now, by increasing the amount of equity in the glidepath. But you also increase the downside risk. There’s an optimal place, so if you get beyond 80% and 90% of income replaced, then you don’t want to add any more risk to the portfolio.”

“We see plan sponsors focusing on a glidepath objective related to retirement income rather than just wealth accumulation,” says Josh Cohen, Managing Director, Head of Institutional Defined Contribution at Russell Investments. “That’s a theme in general within DC plans, and target-date fund glidepath philosophies are starting to reflect that change. There is also much more emphasis on managing the risk when participants are the most vulnerable – at the point of retirement.”

One huge advantage of going custom is the ability not only to set the glidepath, but to

change it according to company circumstance or market developments. “Under normal conditions, we would recommend that a plan sponsor look at the glidepath once a year as a check,” says Voya’s Zemsky. “It’s not just the markets that can change – the demographics of the company could change, if it does an acquisition or a spinoff, or if the employee group changed. But we aren’t going to ask for updated participant data unless there’s been a major corporate event. That we would do every three to five years.”

Developing a glidepath is not just a one-off process. “When you hire a glidepath manager, we think you should hire that firm not just on a project basis, but as an ongoing investment management assignment,” says Russell’s Cohen. “You may want to add tactical tilts and have the ability to reassess what’s going on in the short term. That said, you should take a deeper dive into the demographics every three years or so to check whether there’s been any significant change. If there’s a big event like a merger or acquisition, or a change in benefits, then that should lead to reassessing the broader strategic glidepath.”

It isn’t just circumstances that change. The regulatory environment has developed quickly. “Target-date funds are in their infancy. Laws and products are continuing to change,” says Allianz Global Investors’ Dial. “In addition, participant demographics and savings rates change, corporate structures change, and plan goals change. With this in mind, we think plan sponsors should reassess their glidepath when these changes occur, or at least every three years, to make sure it’s still a good fit.”

Optionality

Plan sponsors are refining their attitude toward glidepath endpoints. “The definition of ‘to’ and ‘through’ has been hijacked,” says Allianz Global Investors’ Dial. “All glidepaths manage the investments after the target retirement date. The difference between ‘to’ and ‘through’ comes down to optionality. A ‘to’ fund gives participants the option to stay in the plan or take their assets out. ‘To’ funds try to decrease volatility because the participants may leave the plan. A ‘through’ fund may have higher volatility at

retirement, because they are managed based on the assumption that participants will stay invested well after the target date.”

In terms of plan objectives as well as participant behavior, understanding and articulating an approach to the transition to retirement is an important area of development with glidepaths. “Our original research suggested a glidepath with a relatively high equity allocation at retirement – what would be generically viewed as a ‘through’ design,” says AllianceBernstein’s Davies. “Our blueprint design goes into retirement with about 65% in equity and other growth assets and would not be de-risked to 35% until about age 80. This would be if there was no DB plan in the mix. A number of our plan sponsor clients are comfortable with this design and implemented it without modification. On the flip side, we recently had a client request a glidepath that minimizes risk at the point of retirement. Here we implemented a low-equity-at-retirement glidepath which is very conservative by industry standards.”

Quantifying risk tolerance is a necessary step in glidepath development. “There’s a lot of theory around risk tolerance and how to measure it,” says Voya’s Zemsky. “We use a term called gamma as a way of measuring the risk tolerance of the participant base. The higher the gamma, the more risk averse they are. We consider that gammas between two and four are appropriate, with a gamma of two as aggressive and a gamma of four being relatively conservative. We put together glidepaths across that continuum and discuss the resulting income replacement ratios, as well as the worst-case scenario. That way we get a sense of where they believe their population might fall on that spectrum.”

The optionality referenced above seems to be coming clearer to participants as they begin to understand the cost implications. “We don’t think plan sponsors should worry about participant transitions and how allocation in the plan might be different from allocation once a participant leaves the plan,” says James Sia, Head of Defined Contribution at GMO. “Many plan sponsors expect that participants will stay in the plan. It used to be the other way around,

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with plans expecting participants to leave, and indeed, that was written into plan documents. From a regulatory perspective, the DOL (Department of Labor) is taking a close look at the IRA rollover decision and redefining the definition of a fiduciary in this instance. The move out of the DC plan into a retail solution involves incompatible fee structures and the DOL is clearly concerned about the effect of that change. Plan sponsors are usually happy to keep the assets, partly because scale keeps fees lower."

Flat glidepath

The higher the level of assets in the target-date fund, the more leverage that plan sponsors have with providers. "Many plan sponsors are interested in keeping participants in the plan for the benefit of the participant, but also for the benefit of the entire plan," says Russell's Cohen. "These assets provide scale, which benefits all the participants. So plan sponsors are thinking about what the appropriate glidepath should be, post-retirement. That doesn't mean that you have a glidepath that keeps sloping down. We actually believe that a flat glidepath through retirement is a more optimal approach and better for retirees who stay in the plan."

Others agree. "We think a flat glidepath in retirement, based on our view of the world and our mathematical modeling, is the optimal glidepath, even for those that are staying in the program post-retirement," says Voya's Zemsky.

"The theory behind our model says there should be an optimal mix between the two main sources of wealth that a person has, which is their expected earnings and financial assets," says Voya's Zemsky. "When you get to retirement, your expected earnings drop to zero and you only have your financial assets. So our glidepath doesn't change post-retirement. But that doesn't mean that we don't design it for people who stay in the program post-retirement."

One of the big developments in glidepath science involves the introduction of manager discretion into the operation of the glidepath. It's an extension of a trend that can be seen across the institutional investment world, a practical answer to increasingly volatile markets. "We prefer the term 'dynamic' to 'tactical' when it comes to asset allocation," says AllianceBernstein's Davies. "Tactical sounds like gunslinging, while we see dynamic asset allocation as more of a risk-control measure. You tend to be able to see market volatility or rising asset correlations coming. These effects tend to last longer, so you can act on them. We see dynamic asset allocation as often taking risk off the table, when we see that it is uncompensated in the market. And occasionally, we can take advantage of return opportunities as well."

Dynamic asset allocation isn't just available in custom glidepaths. "We expect to see more

use of dynamic asset allocation around the glidepath," says GMO's Sia. "Half of the target-date providers that offer off-the-shelf have added some sort of tactical component around the glidepath since 2008. I think this makes sense, because the equity allocation shouldn't be the same in 1980 as it was in 2000."

Minimizing risk

A more flexible approach to asset allocation allows for the changing nature of risk over time. "Even if we have the strategic view that a higher level of equity is good most of the time, we now have tools that tell us when we aren't being paid for taking that equity risk," says AllianceBernstein's Davies. "Some plan sponsors are asking

Even if we have the strategic view that a higher level of equity is good most of the time, we now have tools that tell us when we aren't being paid for taking that equity risk



us to start with a more moderate baseline glidepath and then use our risk tools and judgment as part of a custom program to lean in or lean out – use our discretion to take risk off the table or pursue opportunities. This is an element of custom target-date where we weren't seeing interest five years ago, but are now."

"Dynamic asset allocation can be implemented in a number of ways," says AllianceBernstein's Davies. "We set rebalancing bands between asset classes and have trigger points that tell us when to rebalance. Practically, these bands could expand to give us additional discretion. In other cases, we could add a derivatives overlay program allowing us to modify the underlying risk exposures more efficiently."

The point of dynamic glidepaths in target-date funds is often to minimize risk because certain risks can have a disproportionate effect on participant outcomes. "Volatility matters – not because people have some sort of psychological risk aversion, but because as it gets greater, the difference between the most likely outcomes and the average outcome grows," says GMO's Inker. "And the likely outcomes relative to the average outcome get worse and worse."

Of course, the ability of any asset allocation – dynamic or static – to get participants to their goals depends on the amount they are saving. "If you save more, then you're more likely to have enough money in retirement," says GMO's Inker. "The wonderful thing about being dynamic in a value sense is that you can both increase the expected returns and crucially cut off those nasty left tails. You can make the bad events significantly less bad."

Plain vanilla

Going custom provides plan sponsors with the ability to use a wide variety of asset classes to execute a glidepath strategy. Many custom target-date funds today are taking advantage of this freedom. "If you look at the glidepaths of the major players in the target-date space, they are pretty plain vanilla in their underlying asset allocations," says AllianceBernstein's Davies. "They use mainly stocks and bonds, so the risk is concentrated in equities even when you approach retirement. Typically, the only diversifiers are a small slice of REITs (real estate investment trusts) and TIPS (Treasury inflation-protected securities), which are in there as a basic type of inflation protection. In discussions we are having

today with plan sponsors, we see more interest in further inflation protection, even though we haven't had the problem for a long time. Other 'real asset' classes that could be easily included are commodities and natural resource equities."

Of course, the broader opportunity set is being used across all target-date funds. "Both custom and off-the-shelf target-date funds are enhancing their solutions to provide a greater amount of asset diversification within the glidepath," says Russell's Cohen. "Often it is first movers in the custom sphere that use alternatives, for instance, but then once that gains popularity in custom solutions, you tend to see off-the-shelf solutions starting to incorporate those asset classes as well."

Just because a custom target-date fund has the ability to use a variety of asset classes doesn't mean that they have to do so. "Having a broad opportunity set can be really important, although having a 2% allocation to international real estate is not going to have a big impact on your portfolio," says GMO's Inker. "We think diversification should start from the global opportunity set. But the value of diversification really grows as you allow some dynamism into the portfolio, because the real importance of having international stocks as well as U.S. stocks is not that international outperforms in the long run. They don't. But there are some times when international stocks are priced a lot better than U.S. stocks. So having the opportunity to tilt the portfolio significantly in favor of international stocks at that time is a big deal."

This type of decision is probably best left to the professionals. "Once the glidepath is set in

continues on page 12

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1. As of May 31, 2014

custom, you have the ability to get as granular as you like,” says Voya’s Zemsky. “We wouldn’t suggest going too granular as a plan sponsor, leave that to the professionals. But you can decide what your limit is on liquid alternatives or how you feel about commodities. You can discuss, for instance, you or your consultant’s outlook on inflation and see how the manager will manage these specific risks.”

One decision plan sponsors will want to consider, once the asset class lineup is decided, is whether to use active or passive managers in these choices. It’s a choice that can sometimes be dictated by experiences in the DB world. “In conventional asset classes, plan sponsors definitely have a desire to use the same managers that they use in the full lineup,” says Voya’s Zemsky. “Hopefully, you get fee-stacking and lower fees for the participants. In esoteric asset classes like commodities or liquid alternatives, then these might not be available in the current lineup and most likely wouldn’t be offered on a standalone basis.”

Spending fee and risk budgets

In general, one of the advantages of custom is the ability to pick and choose active and passive. “We see plans using a combination of both active and passive funds,” says Russell’s Cohen. “This is the nice thing about custom. Plan sponsors can systematically make an asset-class-by-asset-class evaluation on where they want to spend their fee and risk budgets instead of dogmatically saying they want either all active or all passive.”

“One of the issues of adopting off-the-shelf target-date funds is that you may have to choose either active or passive management,” says AllianceBernstein’s Davies. “I would say of our over \$20 billion in custom implementations, three-quarters of plans use a mix of active and passive management. For sophisticated investors, this mix is driven by a combination of the fee budget and the active management conviction of the plan.”

“Part of the active-passive choice depends on the goal of the plan sponsor,” says Allianz Global Investors’ Dial. “Is it cost or risk mitigation? Is it something in between? If the goal is to get the cheapest target-date fund, then they will go passive. If the goal is risk mitigation, they’re going to go more active. If it’s in between, then it will probably be a combination built around an expense target.”

“The real asset strategies offer significant opportunities for active management,” says AllianceBernstein’s Davies. “There are a lot of inefficiencies in those markets and some of the indices aren’t that well-constructed. These strategies are often the first active management used when plans step out from passive constructions, but they are more expensive.”

Cost is a consideration. “We think there is active potential in most, if not all, asset classes,” says Russell’s Cohen. “That said, it’s a fee- and risk-sensitive world in DC land. And it’s a

resource-constrained world. So we see plans spending their budgets in areas that tend to be less efficient, like real assets, emerging markets, small cap equities and high yield bonds. We see a greater use of active management in these asset classes.”

Fees may not be the only criteria. “The trend in custom target-date continues to be hybrid, where plan sponsors recognize that in some cases, active management can add a lot to the portfolio,” says Voya’s Zemsky. “The more sophisticated plan sponsors are looking for best value rather than the lowest fee.”

“As an industry, I don’t think we’ve done a good job reiterating the value of active management, so now we have a race to the bottom,” says Allianz Global Investors’ Dial. “If you choose an index, it will underperform the benchmark by the expense ratio every single year. Many underlying funds do not strive to provide protection during a down market – especially when you look at fixed income. In European countries, the focus is on risk mitigation and predictability of income.”

Minimizing expected shortfall

This is the kind of objective that asset managers can use to implement a sophisticated glidepath solution. “You need to have a fully articulated objective for the fund that respects the problem you are trying to solve, and we think a strong case can be made for minimizing expected shortfall while retired to avoid running out of money,” says GMO’s Inker. “Otherwise, it’s hard to know what you are supposed to do when the expected returns on stocks and bonds change. It’s a way to use valuation to inform dynamic asset allocation.”

“Valuations really matter,” says GMO’s Inker. “The assumption that asset class returns are stable is flawed. If today the yield on a 10-year bond is 2.6% and seven years ago it was 4.5%, then you know that a buy-and-hold portfolio will deliver less than the buy-and-hold portfolio delivered last time. Your flight path should recognize that. You don’t want a static glidepath. You want a glide channel driven by plausible valuations and expected returns.”

This is because the experience of individuals in achieving retirement goals may not be homogenous, even if the custom target-date fund reaches its objectives. “The relationship between returns and wealth is not as obvious as it might appear from mean variance optimizations – the basic tool of modern portfolio theory,” says GMO’s Inker. “Even if returns are normally distributed, the resulting wealth from earning those returns isn’t. If you’ve got a distribution of wealth that is not normally distributed, what you find is that the average amount of money accumulated is quite different from the median or most likely amount of money. The average tends to be dominated by relatively unlikely events where returns are much higher than expected. We don’t think that those events

are what you’d really focus on with regard to attempting to save for retirement.”

“We think it is important to recognize that the average wealth outcome is not the same as the most common wealth outcome,” says GMO’s Inker. “What matters is that most likely or most common outcome. So focusing on expected wealth is misleading, especially if your concern is about trying to maximize the probability of having sufficient wealth for the plan population as a whole. Minimizing expected shortfall for the most participants is what we think plan sponsors care most about.”

One additional advantage that the greater opportunity set in custom provides is the ability to consider relative valuations, which do not remain static over time. “The largest determinant of a portfolio’s return is its asset allocation,” says GMO’s Sia. “Our data shows that the correlation between current value and subsequent 10-year returns over a seven-to-10-year period is pretty high – 0.5 or 0.6. Using valuations to inform decisions for one, two or three years is not that helpful. But using it to inform decisions that pay off over seven to 10 years, that’s very valuable. This is, after all, a 70-year problem.”

“Valuations of stocks and bonds have been mean reverting in the past, which means that as time horizons lengthen, the predictability of stock and bond returns gets higher,” says GMO’s Inker. “One nice thing about the retirement savings problem is that it’s a really long problem. You have 40 years of saving for your retirement and you have 30 years perhaps of spending your savings in retirement. That is more than long enough for value to do its job.”

Looking forward

Necessarily much of the information used to construct glidepaths is historical, but the challenge is in scoping the future. “We expect to see the continuing development of glidepath science,” says Voya’s Zemsky. “That means not just looking at historical demographic data, but trying to understand what the demographics will look like going forward and incorporating that information. We also expect to see more guaranteed income offerings within the glidepath, particularly as interest rates rise and the guarantee rates go up.”

And the direction of the industry is clear: custom doesn’t just mean customized to a plan or a company, but to an individual. “Customizing the glidepath isn’t just about demographics,” says Russell’s Cohen. “Very few populations are homogeneous. So you are faced with choices. It is why we think the future of custom target-date funds is customization at the individual level based on each situation.”

As some succinctly put it: “Target-date is not great as an asset allocation solution, except that it is better than participants left to their own devices,” says GMO’s Sia. “Glidepaths can be improved, and could be customized at the plan and individual level.” ⇨



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The Changing Landscape



With current asset flows into target-date, it's no wonder that fiduciary and regulatory matters are high on plan sponsors' list of concerns

The current focus on custom target-date funds can partly be traced to the publication last year of a nudge from the Department of Labor. "Last year, the DOL issued guidance in the form of tips for plan sponsors that specifically suggested that they consider custom target-date solutions," says Glenn Dial, Managing Director and Head of U.S. Retirement Strategy at Allianz Global Investors. "That sparked interest and now plan sponsors are kicking the tires, not making a snap decision, but taking the time to think about custom."

As plan sponsors ruminate, the industry is focused on answering their questions. "The DOL tip sheet has definitely had an impact in terms of interest in custom target-date funds," says Josh Cohen, Managing Director, Head of Institutional Defined Contribution at Russell Investments. "The trend I observe is that plans are looking to enhance the target-date solution. Many plan sponsors added target-date funds around the time of PPA - 2006 - when they needed a default solution. Often they simply chose their recordkeeper's target-date fund. Now these funds are garnering a lot more assets due to auto-enrollment and even re-enrollment. Plan sponsors, and their consultants and advisors, are reviewing the solution to make sure that it's of institutional quality and best-in-class. The end result could be to stick with the fund they have, adopt a better off-the-shelf solution that's not necessarily tied to their recordkeeper, or go custom."

Not sufficient

Fiduciary guidance suggests that a plan should engage in and document a process for choosing a target-date fund or any other qualified default investment alternative. "The DOL tips issued for target-date fiduciaries has been fairly influential in getting plan sponsors to re-evaluate their target-date selection," says James Sia, Head of Defined Contribution at GMO. "Simply choosing your recordkeeper's target-date fund is not a sufficient process. You need to make sure that

the glidepath is representative of your employee population. It also specifically mentions that if you have a certain scale, you should think about going to multi-manager portfolios. It's refreshing that the DOL chose to issue a document like this."

"The DOL tips have had an impact because some sponsors have held back from thinking about custom because it was thought too new, too cutting edge or not mainstream," says Julie Stapel, Partner in the Employee Benefits Practice Group at Morgan, Lewis & Bockius. "But when the DOL suggested considering custom, that perception may have changed and given plan sponsors a higher level of comfort with exploring custom."

Open architecture

Some plan sponsors still appear to think that choosing the recordkeeper option is the best option. "It's a bit perplexing to me that plan sponsors feel more comfortable picking an off-the-shelf solution that's not customized for their workforce vs. having a custom solution that hopefully offers a better outcome," says Paul Zemsky, Chief Investment Officer of Multi-Asset Strategies and Solutions at Voya Investment Management. "When we do a custom program, we can deliver a document to the plan sponsor that says, 'This is what we did, this is why we did it and this is why we think it's appropriate.' Hopefully, that gives comfort."

The legal position is clear. "I'd like to clear up the perception that custom must be more risky from a fiduciary perspective," says Morgan, Lewis' Stapel. "In fact, there may be reasons why custom is less risky because of the lower cost, greater transparency and the ability to get best-in-class management. Both custom and off-the-shelf target-date can present fiduciary risks if plan fiduciaries do not thoroughly understand how the glidepath works, what the underlying investments are, what the fees are and how you are going to measure success. We think that on the custom side, fiduciaries may actually have more ability to control these elements."

Others concur. "The fiduciary advantages of custom are starting to loom larger," says

Richard Davies, Senior Managing Director and Co-Head of North American Institutions at AllianceBernstein. "I think it's natural because, often through auto-enrollment, target-date funds have garnered significant new asset flows. There's a risk that these flows will reverse the decades-old trend to move away from bundled arrangements to open architecture."

Risk is a key issue. "The DOL tips and the SEC (Securities and Exchange Commission) request for comments both focus largely on risk, not fees," says Allianz Global Investors' Dial. "Yet the vocal minority in the industry has turned the risk discussion into a fee discussion. I think the focus should be on risk and value. You should have reasonable fees for the services rendered."

"If you think about it, off-the-shelf and custom have all the same parts," says GMO's Sia. "The difference is between hiring one person or hiring many people. A team of people means you have a diversity of skills and a diversification of risk, which is positive from a fiduciary perspective. But the market will ultimately be judged on whether it provides sufficient retirement income."

Target-date funds continue to be on the regulatory agenda. "Both the DOL and the SEC have regulatory projects pending to provide additional guidance on target-date funds, particularly around disclosures," says Morgan, Lewis' Stapel. "If those regulations were to go in a direction that made it much harder to do custom, then that would have an adverse development on the market. I don't know that I would expect this given that the DOL tips specifically mentioned custom."

Others hope that the DOL weighs in on other related issues that confound plan sponsors. "We're hopeful that the DOL will offer some useful process guidance or amendments to existing safe-harbor protections around in-plan annuity selection," says AllianceBernstein's Davies. "Many plan sponsors are interested in it but not comfortable with the insurer selection process. I think there is pent-up demand - plans would like to act." ↔

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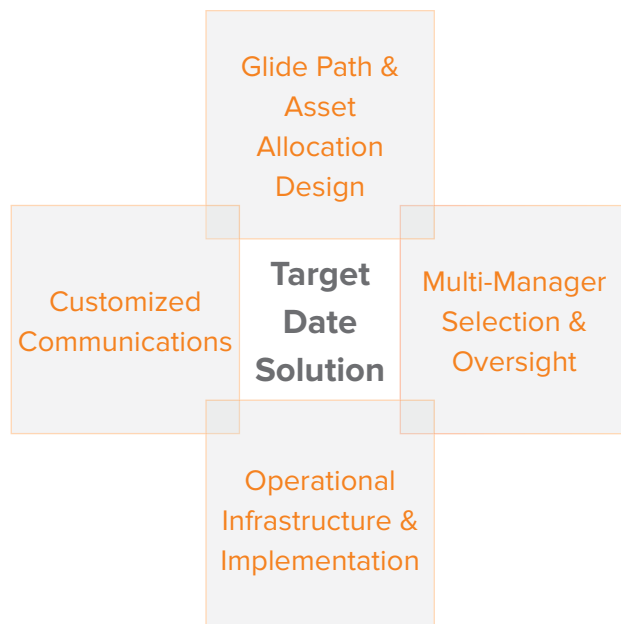
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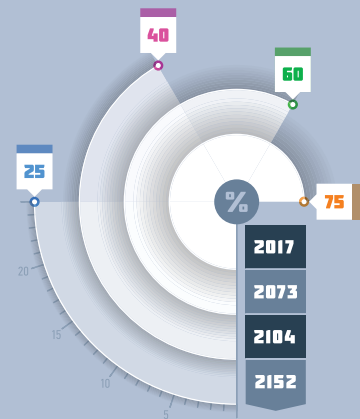


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