
The Morningstar Investment Management Group

Why Human Capital Matters to Retirement Plan Participants



Whether your participants are web developers in California or cattle ranchers in Wyoming, vocation and location should have an impact on the design of a custom target-date solution.

New research from the Morningstar Investment Management group, “No Portfolio is an Island,” indicates that employers should consider more than stocks and bonds when developing the optimal asset allocation in custom target-date solutions. Financial assets represent only one aspect of a person’s total wealth. A participant’s human capital, home location, and pension benefits have value that may actually exceed the value of their financial assets. For years, accomplished academic researchers have explored the worth of human capital — defined as a person’s ability to earn and save over time — suggesting that it contributes significant value to a household’s wealth.

Morningstar research concludes that employers interested in improving participant outcomes should consider the non-financial assets of their participant base when developing custom target-date solutions. To illustrate the potential impact on asset allocations, we outline scenarios for three participants and show how taking a total-wealth perspective when designing a custom target-date solution can help participants better prepare for retirement. The corresponding graphs represent notable changes to the participants’ portfolios after considering region, industry, and pension benefits.



Scenario 1

In this hypothetical situation, we discuss how a participant's profession relates to retirement planning and how employers can help guide participants toward diversified portfolios.

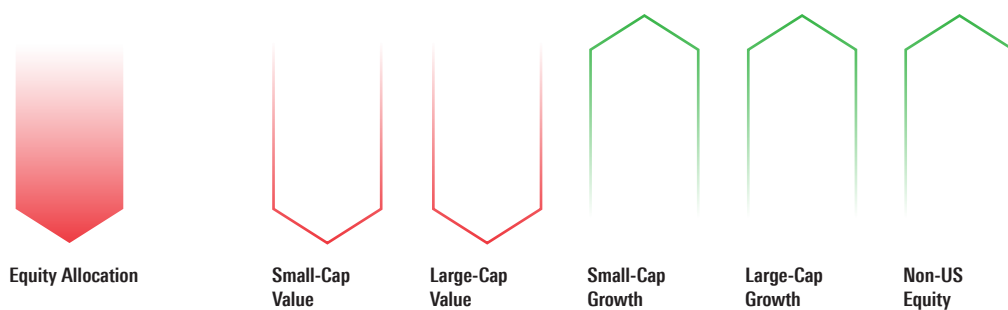
Maria is a stock broker.

Maria owns a home in Minneapolis, a thriving city with a stable real estate market. As a financial professional, she works in an industry that tends to be volatile. When the markets are prospering, financial services companies are likely to pay employees well and hire often. In times of turmoil, financial professionals are susceptible to layoffs or significantly lowered pay.

Because of the risk associated with her vocation, Maria should consider her ability to earn when constructing a retirement portfolio. Maria's human capital is directly tied to the general strength of the financial services sector, which is highly correlated to asset classes such as large-cap value.

What options can her employer offer?

It's prudent for Maria to invest less of her assets in large-cap value given its high correlation with the financial services industry. Maria's employer can offer a better choice for Maria and her colleagues based on their workforce demographics with a custom target-date solution that underweights large-cap value.



For illustrative purposes only.

Equity Allocation

Due to the volatility in the financial services industry, Maria's equity allocation should be slightly less than that of a typical investor.

Notable Changes to Sub-Asset Classes

U.S. value equities tend to be correlated to the performance of the financial sector, so we shifted Maria's portfolio away from U.S. value equities and toward asset classes that are less related with the financial services industry, such as U.S. growth equities and non-U.S. equities.



Scenario 2

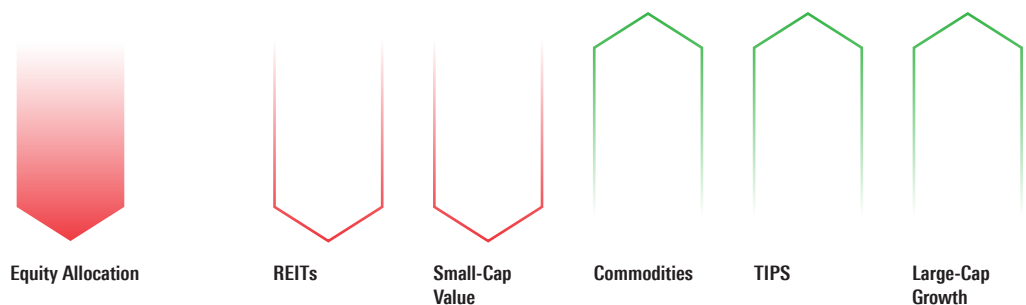
In this hypothetical situation, we discuss how a participant's home location relates to retirement planning and what approach an employer can take to help mitigate regional issues.

Roger is a radiologist.

As a professional in the health-care industry, Roger's ability to earn is fairly secure. He is also home owner in Las Vegas, one of the 10 cities we studied in "[No Portfolio is an Island](#)." Homeowners in Las Vegas had the most significant changes to their optimal portfolios after we factored in region-specific housing wealth. Employment in the health-care industry is steady, so Roger isn't necessarily in danger of losing his house, but the risk associated with the location of his home could result in a decrease in his net worth. Roger should consider the value of his home when planning for retirement.

What options can his employer offer him?

Based on our research, the financial assets of homeowners in Las Vegas should generally be invested more conservatively than average, considering the city's historically volatile housing market. Roger's employer could offer a custom target-date solution specifically designed to mitigate the intrinsic risks associated with the region. Since Roger's total wealth is more correlated to the real estate market, he can manage that risk by holding fewer financial assets in real estate investment trusts and real estate properties.



For illustrative purposes only.

Equity Allocation

Roger's financial assets should be invested more conservatively than that of a typical investor because of the historic volatility of the Las Vegas housing market.

Notable Changes to Sub-Asset Classes

Roger's housing wealth is tied directly to his location in Las Vegas, known for its volatile housing market. But he also works in a relatively low-risk profession, health care. To offset the inherent volatility tied to the housing component of his assets, we shifted his portfolio away from REITs. We also reduced the allocation to small-cap value and increased the allocation to commodities, and Treasury Inflation-Protected Securities to offset some of the industry-specific risks associated with working in health care.



Scenario 3

In this hypothetical situation, we illustrate how both a participant's home location and profession relate to retirement planning and why participants might consider these factors when their human capital is tied directly to the region where they live.

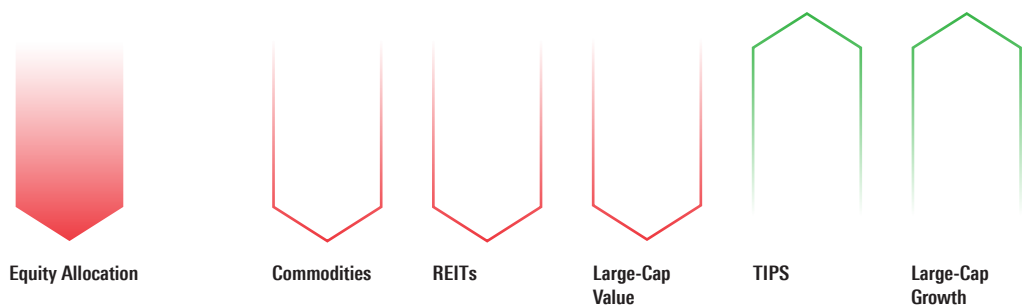
Joe is a field engineer.

Joe works in the oil industry and is heavily invested in the default option of his company's 401(k) plan, an off-the-shelf target-date fund. Joe owns his home in Houston, a hub for oil operations in the United States. His ability to earn is tied directly to the energy industry. In other words, Joe's human capital is significantly more connected to the energy sector than that of the average U.S. retirement plan participant.

If Joe's portfolio has substantial exposure to the energy industry by way of energy stocks or commodities, his total wealth could be precariously concentrated in energy. The risk of job loss and the risk of volatility in his portfolio go hand-in-hand.

What options can his employer offer him?

Joe's employer could provide a custom target-date solution specifically designed to underweight asset classes with high correlation and exposure to energy stocks and commodities.



For illustrative purposes only.

Equity Allocation

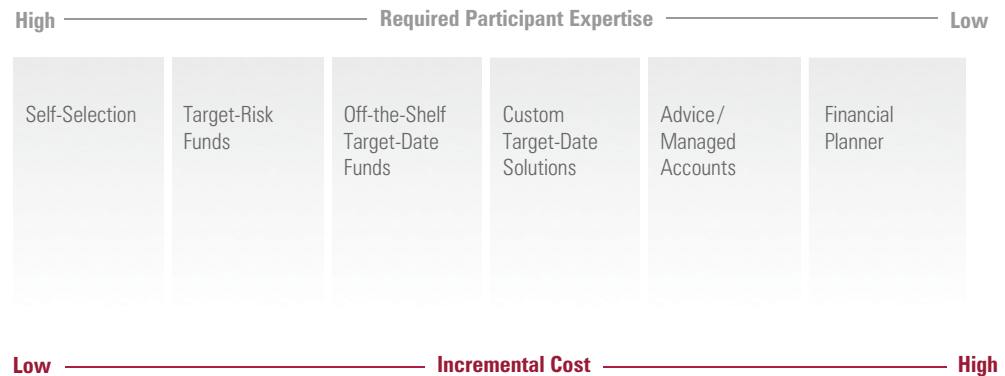
Based on the risks associated with his profession and the location of his home, Joe should invest more conservatively than a typical investor.

Notable Changes to Sub-Asset Classes

Joe's portfolio should take on less risk overall, so we moved his portfolio away from asset classes such as REITs, commodities, and value equities, and shifted toward TIPS and growth equities.

A Data-Driven Approach to Retirement Plans

A clearer view of a workforce's total wealth emerges when you add detail about the company's industry and the regions where its employees live. The risk factors connected to industry-specific human capital and housing location will vary by employer, but these specifics should factor into a custom target-date solution. According to our research, using a total-wealth approach when designing target-date solutions for retirement plans can significantly change an optimal allocation, with average asset-class differences exceeding 20%.



The professionals in the Morningstar Investment Management group believe that custom target-date solutions represent an option that delivers the benefit of professional investment expertise without extensive participant involvement. Demographic and workforce data is readily available for plan participants, and employers should use that information to build custom target-date solutions.

Our philosophy suggests that the more an employer tailors its participants' retirement plans to the demographics of the workforce, the more likely the plans are to guide better investment outcomes.

About Our Research

The research team within the Morningstar Investment Management group pioneers new investment theories, establishes best practices in investing, and develops new methodologies to enhance a suite of investment services. Published in some of the most respected peer-reviewed academic journals, the team's award-winning and patented research is used throughout the industry and is the foundation of each client solution. Its commitment to ongoing research helps maintain its core competencies in asset allocation, manager research, and portfolio construction. Rooted in a mission to help individual investors reach their financial goals, its services contribute to solutions made available to approximately 24.3 million plan participants through 238,000 plans and 26 plan providers.

About Our Custom Solutions

At the Morningstar Investment Management group, we provide investment advisory services to clients worldwide. Our target-date methodology is rooted in respected academic theories, including our patented methodology* that introduces the concepts of human and financial capital. We use your participants' unique demographic data to build customized glide paths to match their distinct characteristics. We design solutions using open architecture, implemented with the funds you've already vetted for participants. We can serve as a 3(21)(A)ii or 3(38) fiduciary to help you manage your fiduciary responsibilities.

Tailored Training and Communications

We'll collaborate with you on a customized communication plan to help engage participants and manage change for your entire organization. We provide training in various formats, and create easy-to-understand materials to help educate all levels of the organization. And we work with you to communicate directly to your participants prior to and throughout the rollout.

Learn More

Contact us today to explore how our custom solutions may help you provide solutions that help your participants reach their retirement goals

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*The human capital methodology was developed by its patent holder, Ibbotson Associates, Inc., a registered investment advisor and wholly owned subsidiary of Morningstar, Inc.

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