FRANKLIN TEMPLETON

White Paper

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INNOVATION IN DEFAULT INVESTING

Why personalization in qualified default investment alternatives (QDIAs) is imperative to delivering better participant outcomes

Imagine for a moment that we could remove the many barriers that get in the way of individuals saving and investing for retirement using workplace plans. Imagine a world free of outdated technology platforms, cost prohibitive investment designs, poor behavioral tendencies, and litigation fears. If given the chance to cleansheet the entire experience, how would we design an investment default for those participants who simply take the path of least resistance and don't provide any direction for the investment of their contributions? We'd be wise to start with a question: *"What do we know about each particular individual?"*

Past – A look back at default investment evolution

In 1974 The Employee Retirement Income Security Act (ERISA) was born, setting a standard for employer sponsored retirement plans. In the decades that followed, as the defined benefit (DB) to defined contribution (DC) shift became a reality, the term 'default' took on a whole new meaning and we learned quite a bit about participant behavior. Specifically, education is not enough to overcome inertia, and participants require some mechanism to make sound investment decisions for them. In the early 90s target date funds (TDFs) emerged as a solution to do just that, with the ability to help improve age-appropriate diversification and move the investment decision making away from the participant and to investment professionals. At the time, cash equivalents were the typical, and perceived safe, default investment, and encouraging participants to move into these TDFs became another hurdle.

Then came the Pension Protection Act (PPA) of 2006, which provided certain fiduciary protections for assets defaulted into a qualified default investment alternative (QDIA) encouraging plan sponsors to make an *active* decision to change the plan's default investment. This, coupled with automatic enrollment, automatic contribution escalation and re-enrollment, accelerated the growth of TDFs, which quickly became the QDIA of choice.

Qualified Default Investment Alternatives Defined

Life-cycle or targeted-retirement-date fund: a product with a mix of investments that takes into account the individual's age or retirement date

Balanced fund: a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual

Professionally managed account: An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date

Many of the innovations we have seen since 2006 have been in the TDF space. The industry moved from vintages in 10-year increments to 5-year increments, from a single TDF option on the recordkeeping platform to multiple options and from single manager offerings to multi-manager solutions, and even custom structures that account for plan demographics. And they have been a positive force in helping to improve where we were placing defaulted money. But they do not come without some flaws, namely that they largely focus on one data point – age – based on five-year age bands and are designed for a *typical* participant, not a *specific* individual. Therefore, they are unable to accommodate an individual's unique needs and circumstances and, importantly, his/her holistic household picture.

Managed accounts had their own challenges. Limitations in technology often meant recordkeepers were only providing age and balance to a managed account provider. Therefore, fiduciaries had a tough time justifying the fees for little incremental personalization. They also were operationally challenged and required a lot of participant engagement at the outset.

Regardless, the industry had learned a lot and started to think about the next evolution of default investing.

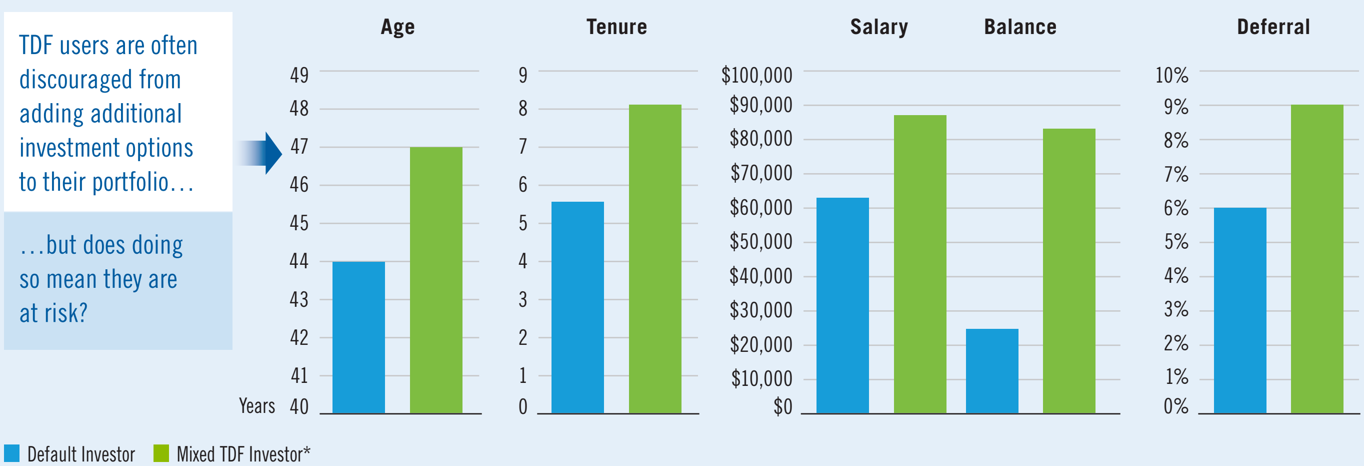
Present – A sharper focus on outcomes

As of year-end 2018, TDFs made up 27% of 401(k) assets and the majority (58%) of net flows.[1] After a decade long bull market, they worked well, especially for younger workers just starting to save for retirement. However, innovation largely stalled.

At the same time, we have realized where we need to go. People have different needs at different points of their financial lives. There is increasing recognition that defaults have worked well for younger workers, but do not necessarily deliver the best experience for mid-and-late career workers who are less similar. Take plan design defaults, for example, and the experience of an individual who was contributing 10% to a DC plan thanks to years of automatic escalation at their prior employer. Say they change employers and are told they will start at 3% unless they opt to change the rate. Did a one-size-fits-all default structure make sense for that individual, or make him or her feel like the employer knew anything about them? What about *investment* defaults for this population? Research shows that many individuals are looking for more than TDFs can offer, based on the actions they are taking with those investments, particularly in these later years when their balances are likely higher and they are less likely to cash out. Let us also think about whether today's defaults have been able to successfully handle decumulation needs. Here, the need for personalized solutions becomes even more important as spending decisions are highly unique to an individual's circumstances.

EXHIBIT 1: Are mixed TDF investors making a mistake?

Attributes of default investors versus mixed TDF investors



*Mixed TDF implies any allocation other than full TDF usage.

Source: Mixed Target-Date Fund Investors – Is There a Method to the Madness? whitepaper, Morningstar, 2019.

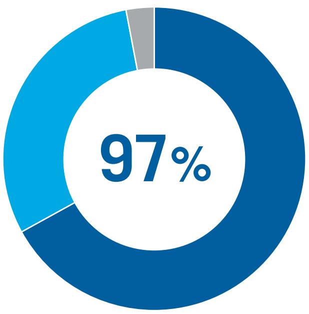
With improved integration among managed account providers, investment managers, and recordkeepers, managed accounts are becoming more personalized without requiring more engagement from the participant, and costs have started to come down. However, obstacles still exist, and accessing advice for the average plan participant remains a challenge, even though American workers are looking to their employer for help. According to our research, 97% of participants feel it is important for their DC plan to include investment options that are specifically designed to help turn savings into a regular stream of income.

1. The Cerulli Report – U.S. Defined Contribution Distribution 2019 – Opportunities for Differentiation in a Competitive Landscape.

Another 86% say it is important for their employer to offer resources and assistance for other non-retirement financial planning services.[2] Managed accounts can play a larger role in successfully making this connection. We no longer need to wait for participants to give us data. We have additional data that we can consider. Managed accounts will not gain widespread adoption if participants need to opt in. Instead, they need to be the QDIA. As we continue to move toward more personalized solutions, we also cannot wait for the perfect world scenario where we are able to incorporate every data point that might be available to us. We know more about participants than age so why wait to use that knowledge?

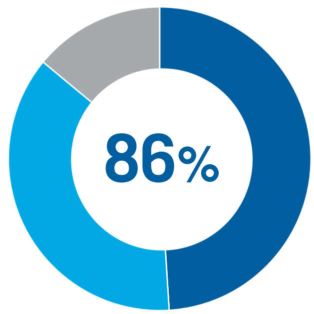
EXHIBIT 2: American workers look to employers for support

How important is it for your employer sponsored retirement plan to include investment options that are specifically designed to help you turn your savings into a regular stream of income throughout your retirement?



"Help me turn my savings into a stream of income"

How important is it for your employer to offer resources and assistance for other non-retirement financial planning services (for example, saving for college, managing debt, etc.)?



"Provide me with non-retirement financial planning services"

■ Very Important ■ Somewhat Important

Note: 2020 Total n = 2,004; Currently participates in workplace retirement plan n = 698.

Source: Franklin Templeton Retirement Strategies and Expectations (RISE) survey 2020.

EXHIBIT 3: Age is not the only variable. The data points about participants that we collect, analyze and communicate fall into four categories:

Data we know

1 Directly observable data

Objective statistics that exists on current systems

- Age
- Tenure
- Salary
- Marital status
- Current balance
- Savings rate
- Other savings vehicles

2 Data we can calculate

From readily observable data

- Retirement readiness calculations
- Has the participant overridden a default (such as saving more than the auto path)

3 HR Information System

Additional data can also be accessed through the HRIS

- Defined benefit plan
- HSA participation
- 529

What we can infer

4 Big data used to make inferences

Big data sets allow us to infer approximate information about important retirement-related statistic. For example:

- For short-tenured older workers, what's the likelihood and amounts of prior savings?
- For married participants, what's the likelihood and amounts of the spouse's savings?
- More likely retirement age (than the outdated age 65), along with likely tax-qualified drawdowns

2. The Franklin Templeton Retirement Strategies and Expectations (RISE) survey 2020 was conducted online among a sample of 2,004 adults comprising 1,002 men and 1,002 women 18 years of age or older.

Investment default success metrics of the past, present and future

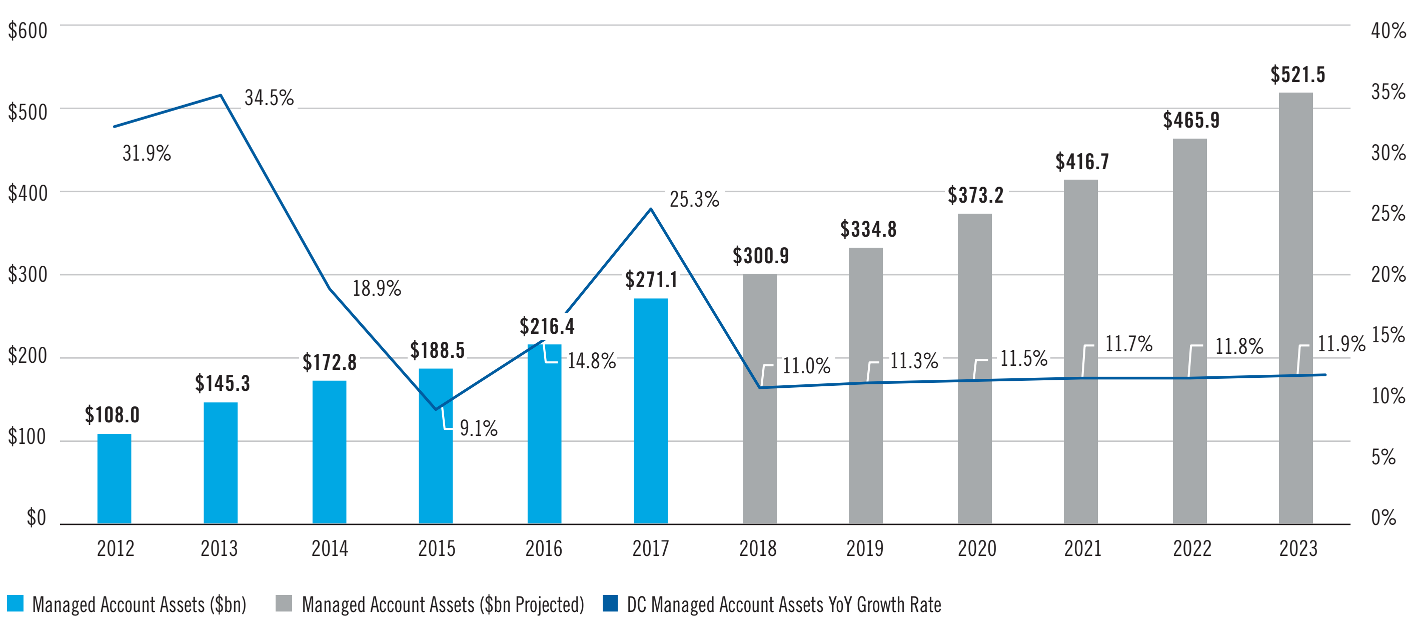
Past	Present	Future
Are my employees diversifying beyond the default (cash)?	Am I covered as a fiduciary for the default in my plan?	Does my default help my employees achieve their goals?

The future – Improved outcomes through greater levels of personalization become reality

We expect Netflix to recommend what we might like to watch next. We expect Spotify to automatically create playlists for us based on our song history. Why wouldn't we apply these same levels of personalization to our financial lives? Fiduciaries are asking these questions and shifting their success metrics from '*how many employees are participating in the plan?'* to *'how many employees are on track to achieve their goals?'*. These are the questions driving innovation and the shift toward offering more cost-effective, personalized investment advice. Stronger integration, accelerated by technology, across all aspects of the DC space and beyond will allow plan participants to understand how their 401k plan fits into their broader financial picture – arming them with the information they need to make more informed, and truly personalized, financial decisions.

Managed accounts that focus on helping individuals achieve a goal are one mechanism within the DC space that can help realize this future. More competition should mean improved pricing, innovation in technology, standardized benchmarking, and more platform/product choice. Access to more data will help overcome required participant engagement yet encourage it when individuals are ready. We will also encounter solutions that incorporate not only market conditions and outside of plan assets, but also additional circumstances like health status, debt levels and the number of children in the household. Innovation will also demand increased simplicity and a more thoughtful ecosystem, with more connection between DC plans, payroll providers, banks and other financial and health institutions – all working together to ensure the highest level of connectivity between solutions and an individual's unique needs and circumstances.

EXHIBIT 4: Managed account assets projected to outpace asset growth of overall DC market



Source: Cerulli U.S. Defined Contribution Distribution 2018: An Update on Managed Account Assets in DC Plans.

As we continue to progress toward the future, there is much for us to think about. We do not anticipate a single solution will be perfect for everyone, rather we acknowledge the need for a range of possible solutions where an individual can find their best solution.

CONSIDERATIONS FOR ERISA FIDUCIARIES

"Because of the explosive growth of automatic enrollment, one of the most important decisions many fiduciaries make today is to determine which investment will serve as the plan's default, also known as the qualified default investment alternative."[3]

Michael Hadley, Partner, Davis & Harman LLP

Considerations for selecting which QDIA type may be best for your plan

- Have you evaluated the benefits of each type of QDIA?
- Have you analyzed your plan demographics to identify underserved participants?
- Is the default aligned to the plan's success metrics?
- Do you understand the probability of success for each plan participant?

Considerations for selecting and monitoring managed accounts as a QDIA

- Does the plan's recordkeeper offer one or multiple managed account options? If multiple, have you evaluated the differences in capabilities, governance, and functionality?
- What investments are being used within the managed account?
- Who is providing investment oversight?
- What is the assignment methodology used by the managed account provider?
- Do you understand the fees and how they compare to other offerings in the marketplace?

Franklin Templeton Defined Contribution

For more than twenty years, Franklin Templeton has been dedicated to helping plan sponsors, in partnership with their advisors and consultants, make informed plan design, fiduciary and investment-related decisions to help participants achieve retirement success. We are committed to providing our clients with plan-related insights and resources across a broad spectrum of industry topics.

3. Goal-based Personalization in Managed Account Investing: Considerations for ERISA Fiduciaries whitepaper. Davis & Harman LLP.

Franklin Templeton is dedicated to improving the financial well-being of the American worker. Reach out to your Defined Contribution contact or visit www.franklintempleton.com to access additional resources and to learn more about how we are helping clients implement these ideas.

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