



To: Supplemental Retirement Board of Trustees

From: Kevin SigRist, Chief Investment Officer  
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Date: February 10, 2017

Subject: Delegated Glidepath Evaluation

This memorandum addresses the management of the “GoalMaker® Funds” investment options provided to participants in the North Carolina 401(k) and 457 Plans (“NC 401(k) / NC 457”). Recommendations to the Supplemental Retirement Board of Trustees (“SRP Board”) are presented on page 4.

## Background

Since 2009, the SRP Board has authorized a set of asset allocation models (“Model Allocations”) for NC 401(k) / NC 457 participants that desire a professionally constructed asset/fund allocation. The Model Allocations are a modified version of an off-the-shelf asset allocation model from Morningstar. Morningstar provides their services to Prudential Retirement, as the plan recordkeeper, and the allocations are presented to the participants through Prudential’s GoalMaker® service offering as GoalMaker® Funds. The recordkeeper automatically allocates any contributions and distributions across the investment options in the model, in order to maintain the targeted Model Allocation. The recordkeeper rebalances the allocation across the investment options back to the target allocation on a quarterly basis. Within the GoalMaker® service a participant can optionally elect a feature, known as “Age Adjustment,” which automatically keeps the participant on a glidepath within the risk tolerance selection based on the number of years until retirement or point of withdrawal. Participants who elect the GoalMaker® Funds service have 100% of their NC 401(k)/NC 457 Plan balance invested in the offering.

The Model Allocations may utilize all of the authorized investment options, but they are not required to if it is determined by the SRP Board that a particular investment option is not additive to a given risk tolerance and investment time horizon. The authorized Model Allocations are contained in the Investment Policy Statement and are reproduced in Appendix 1 of this memorandum.

The SRP Board provides for a “Default Investment Option” when a plan participant has not made an affirmative investment election. The SRP Board has chosen the GoalMaker® Funds Moderate Allocation Model with an assumed target retirement age of 65 as the Default Investment Option.

As of September 30, 2016, for the NC 401(k) / NC 457:

1. Total assets in GoalMaker® Funds was \$4.1 billion or 42.7% of all assets.
2. The GoalMaker® Funds utilization among new participants was 90.5%.

3. The GoalMaker® Funds utilization among all participants was 59.2%.

The SRP Board periodically reviews the investment needs of the participants to determine if the investment options line-up or the structure of the GoalMaker® Funds should be modified. Prior to 2016, the NC 401(k) / NC 457 were bundled with Prudential. Prudential and the Mercer Investment Consulting “Mercer”) would evaluate potential changes to the GoalMaker® Funds for the Department and the SRP Board’s consideration. There were two reviews relevant to the GoalMaker® Funds in 2013 and 2015:

1. Morningstar recommended changes to its model asset allocations to Prudential in 2013. Based on analysis of these recommendations from Mercer and staff, inflation responsive and global equity investment options were added and adjustments were made to the active/passive mix. The SRP Board was also receptive to Mercer recommendations to smooth the glidepath and add a “through retirement” or income component to the glidepath. However, the SRP Board deferred the latter changes until after the 2015 unbundling transition.<sup>1</sup> Morningstar annually reviews their asset allocation analysis for potential updates, but since 2013 no changes to the model allocations have been required as it relates to the GoalMaker® Funds.
2. In March 2015, Jeffrey Slocum & Associates, Inc. (“Slocum”) recommended that “the Board... direct the goals, risk profile and acceptable asset classes for each age band, but outsource the asset allocation decisions to an ERISA 3(38)-style investment manager” for the NC 401(k) / NC 457. Slocum also recommended adding a dedicated investment management staff position to help oversee the NC 401(k) / NC 457 investments.<sup>2</sup> The SRP Board approved the addition of the dedicated position and directed staff to review Mercer’s role as investment consultant in a hybrid model and the potential fee. In this hybrid model, Mercer could potentially serve in an advisory capacity for certain duties and could serve as a delegated investment manager for the glidepath.

Post the January 1, 2016 unbundling transition, the Department issued a Custom Target Date Funds Questionnaire to competitively evaluate service offerings and fees of Mercer and other delegated glidepath managers. Six firms received questionnaires, four responded, and ultimately three firms were invited to Raleigh for finalist presentations. On-site due diligence visits were conducted by investment staff with each of the finalist firms in November 2016. The Investment Subcommittee of the SRP Board was last updated on the project at its November 10, 2016 meeting.

## Analysis

In the view of investment management staff, all three finalist firms have strong capabilities in delegated glidepath management, and could reasonably be expected to successfully deliver the following potential services on a delegated-basis for the GoalMaker® Funds:

1. Recommend to the SRP Board the design of the GoalMaker® Funds
  - a. The Risk Tolerance and Investment Horizon parameters/definitions of the GoalMaker® Funds
  - b. The target asset class allocations and through retirement glidepath of the GoalMaker® Funds
  - c. The target Investment Option allocations of the GoalMaker® Funds, including the active/passive mix

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<sup>1</sup> <https://www.nctreasurer.com/ret/Board%20of%20Trustees/NCSRPGoalMakerReview2013.pdf>

<sup>2</sup> <https://www.nctreasurer.com/ret/Board%20of%20Trustees/SRPInvestmentConsultantStructureRecommendation.pdf>

- d. The target allocations to investment strategies/products that are not offered in the Plans as stand-alone Investment Options, but that would materially improve the probability of meeting the objectives of the GoalMaker® Funds
  - e. Tactical asset allocation and rebalancing rules for the Funds
2. Oversee and manage the GoalMaker® Funds on a day-to-day basis
    - a. Rebalancing
    - b. Tactical tilts (if permitted under contractual investment guidelines)
    - c. Monitoring of any investment strategies/products that are not offered in the Plans as stand-alone Investment Options
    - d. Working proactively with the Department, BNY Mellon, and Prudential to support successful delivery of cost-effective GoalMaker® Funds within the existing custody and recordkeeping platforms on a fully unbundled basis
  3. Support a research program that would facilitate future enhancements to the GoalMaker® Funds that would account for:
    - a. Specific characteristics of the Plans such as participant risk tolerance, average account balance, accrued pension benefit, and savings rates
    - b. Defined contribution industry innovations such as income solutions, non-traditional investment strategies/products, and behavioral finance

However, after several rounds of negotiations of service offerings and fees, investment management staff does not believe that the service offerings of the finalists are compellingly cost-effective compared to alternative courses of action by the Department and SRP Board.

1. If the delegated glidepath services were billed on a flat fee basis similar to recordkeeping and other G&A expenses, the fees would range from roughly \$2 to \$4 per year for each participant that utilizes the GoalMaker® Funds. Table 1 shows that the average account balances by age group for participants with assets in GoalMaker® Funds are quite low for the younger age groups; the flat dollar fees at these levels would equate to 2 basis points to 5 basis points per year for the 25-34 age group in the NC 401(k).

**Table 1: Average Account Balances Asset Allocation by Age Group for Assets in GoalMaker As of September 30, 2016**

Age Group	NC 401(k) Plan	NC 457 Plan
Less Than 25	\$2,197	\$644
25-34	\$9,083	\$1,873
35-44	\$20,871	\$4,605
45-54	\$32,871	\$9,308
55-64	\$40,735	\$19,656
65+	\$54,376	\$55,226
Total	\$25,891	\$9,045

Source: Prudential Retirement

2. If the services were billed on an equal basis point charge for all GoalMaker® Funds participants, similar to an asset management fee, then the fees appear low at roughly 1 basis point to 2 basis

points. However, according to the 2015 CEM Benchmark report the NC 401(k) / NC 457 are already at or slightly higher cost than the peer benchmark.<sup>3</sup>

3. There are lower cost alternative courses of action, relative to proceeding with the fully delegated glidepath, that would reasonably still materially improve participant outcomes:
  - a. The 2013 Mercer recommendations that were deferred until after the 2015 unbundling<sup>4</sup> could be finalized by investment management staff with no incremental fees.
  - b. A one-time customized glidepath advisory project could be conducted with an investment consultant at significantly lower cost compared to the fully delegated approach. Several changes to the glidepath could be developed, in conjunction with investment management staff, for the SRP Board's consideration: e.g., increase exposure to growth assets for younger participants within the conservative and moderate Model Allocations; update the participant questionnaire; consider defensive equity or other diversifying strategies; evaluate income-focused strategies for participants in retirement; and incorporate overall plan demographics into glidepath design.
4. There is limited data on actual outsourcing of customized glidepath management, but it appears relatively rare for large plans with dedicated investment management staff and external investment consultant support.<sup>5</sup> Also, since the original Slocum recommendation and SRP Board direction on the outsourced glidepath, significant incremental senior staff and business processes have been added to assist the SRP Board in the oversight of the GoalMaker® Funds.

In 2015, Slocum identified liability management considerations as an important basis for their recommendation to utilize a delegated glidepath manager: *"A delegated ERISA 3(38) manager over custom multi-asset class portfolios reduces liability for North Carolina and provides clarity for responsibility of asset allocation decisions."* To that end, internal legal analysis of the SRP Board's fiduciary duties related to the glidepath is contained in Appendix 2.

## Recommendations

After having gathered relevant competitive fee-for-service information and related fees, investment management staff is comfortable with the following recommendations, in priority order:

1. Do not proceed to contract execution for ongoing fully delegated glidepath services with Mercer or the other 2 finalists.
2. Instruct investment management staff to develop a plan with Prudential to finalize the material changes to the glidepath of the GoalMaker® Funds based on the 2013 Mercer recommendations (i.e., those that were deferred until after the 2015 unbundling) with no incremental fees.
3. If the SRP Board believes a customized glidepath should be pursued then authorize investment management staff to negotiate with the finalists for a one-time advisory project with a clearly defined scope and competitive one-time retainer project fee. SRP Board action would be required before awarding the contract and expenditures or related fees.

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<sup>3</sup> <https://www.nctreasurer.com/ret/Board%20of%20Trustees/6CEMPresentation091715.pdf>. Note: the 2015 CEM report does not reflect reductions in administrative and other fees that resulted from the unbundling.

<sup>4</sup> These include smoothing the glidepath and/or adding a "through retirement" or income component to the glidepath.

<sup>5</sup> The February 2015 SEI DC Plan Sponsor Survey indicates 11% of respondents "are considering or currently using an outsourced Chief Investment Officer arrangement for custom target-date funds."

## Appendix 1: Supplemental Retirement Plans Authorized Model Allocations

The SRP Board has authorized a set of asset allocation models (“Model Allocations”) to be offered to participants of the Supplemental Retirement Plans. The Models Allocations are designed to be sensitive to:

1. **Risk Tolerance.** Participants are able to select their risk tolerance from one of three levels, Conservative, Moderate and Aggressive.
2. **Investment Horizon.** For each of the three levels of Risk Tolerance, four investment horizon models have been selected. These investment horizon models become more conservative, with higher allocations to bonds and stable value investments, as the horizon becomes shorter. Each investment horizon model is designed to be consistent with the participants’ retirement date.

### Conservative Model Allocation

The objective of the Conservative Model Allocation is to achieve long-term growth in excess of inflation with a minimal risk of capital loss over a full market cycle.

Conservative	C01	C02	C03	C04
	0-5 Yrs	6-10 Yrs	11-15 Yrs	16+ Yrs
Large Cap Value	1%	2%	3%	3%
Large Cap Index	4%	4%	7%	8%
Large Cap Growth	1%	2%	3%	3%
Small / Mid Cap Value	2%	3%	5%	7%
Small / Mid Cap Index	0%	0%	0%	0%
Small / Mid Cap Growth	2%	3%	5%	7%
Global	6%	10%	15%	23%
International	3%	5%	7%	11%
International Index	0%	0%	0%	0%
Fixed Income	16%	14%	12%	10%
Fixed Income Index	17%	14%	13%	10%
Stable Value	40%	35%	22%	10%
Inflation Sensitive	8%	8%	8%	8%

### Moderate Model Allocation

The objective of the Moderate Model Allocation is moderate growth of principal with limited downside risk over a market cycle.

Moderate	M01	M02	M03	M04
	0-5 Yrs	6-10 Yrs	11-15 Yrs	16+ Yrs
Large Cap Value	2%	3%	4%	5%
Large Cap Index	5%	7%	7%	10%
Large Cap Growth	2%	3%	4%	5%
Small / Mid Cap Value	4%	5%	7%	10%
Small / Mid Cap Index	0%	0%	0%	0%
Small / Mid Cap Growth	4%	5%	7%	10%
Global	11%	15%	19%	25%
International	6%	7%	9%	12%
International Index	0%	0%	0%	0%
Fixed Income	13%	12%	10%	4%
Fixed Income Index	13%	13%	10%	5%
Stable Value	31%	21%	14%	5%
Inflation Sensitive	9%	9%	9%	9%

### Aggressive Model Allocation

The primary investment objective of the Aggressive Model Allocation is to maximize growth of principal over the long term with a reasonable level of overall volatility.

Aggressive	A01	A02	A03	A04
	0-5 Yrs	6-10 Yrs	11-15 Yrs	16+ Yrs
Large Cap Value	3%	4%	5%	6%
Large Cap Index	7%	7%	8%	11%
Large Cap Growth	3%	4%	5%	6%
Small / Mid Cap Value	6%	7%	9%	11%
Small / Mid Cap Index	0%	0%	0%	0%
Small / Mid Cap Growth	6%	7%	9%	11%
Global	16%	19%	24%	30%
International	8%	9%	12%	15%
International Index	0%	0%	0%	0%
Fixed Income	12%	10%	5%	0%
Fixed Income Index	12%	10%	6%	0%
Stable Value	17%	13%	7%	0%
Inflation Sensitive	10%	10%	10%	10%

## **Appendix 2: Internal Legal Analysis of Glidepath for the NC 401(k) and 457 Plans**

Plan design issues are ultimately the responsibility of the Board, which has a fiduciary duty to select, monitor, and (if necessary) replace investment options in the Supplemental Retirement Plans. N.C.G.S. §§ 135-91(a), 135-91(d), and 135-96(e). To the extent that the Board lacks the expertise to make certain plan design decisions, it is authorized to retain and consult investment experts. To that end, the Board regularly relies on advice from its external investment advisor (Mercer) and internal investment resources (IMD). In addition, the Board has implemented the investment options for the NC 401(k) and 457 Plans by delegating investment discretion to investment managers – either as managers with strategies underneath the overarching white label funds or as a delegated manager over the entire stable value fund. The use of delegated investment managers shifts the Board's responsibility and liability from selecting and monitoring actual investments to selecting and monitoring investment managers. This delegation is consistent with the statutory authority and the resources of the Board and the Department and mitigates the Board's liability for the prudence of the underlying investments, provided that the Board prudently monitors the investment managers.

The Goalmaker service is analogous to a target-date fund (TDF) offering and the Board is responsible for selecting and monitoring (1) the investments utilized (2) the asset allocations/glidepaths utilized; and (3) the expenses of the service. To the extent that Goalmaker utilizes only core investment options (i.e., those available to participants on a stand-alone basis), the additional responsibility and risk involved in offering Goalmaker to our participants is in the selection and monitoring of the glidepath.

The glidepath utilized in the NC 401(k) and NC 457 Plans' is currently based on a modified version of an off-the-shelf asset allocation model from Morningstar, which is provided to Prudential's GoalMaker service. The decision to provide an asset allocation model through a third party (such as Morningstar and Prudential) is a fiduciary act, and the fiduciary's obligation is the prudent selection and monitoring of the provider of the model. Morningstar's glidepath was revised somewhat by IMD and Mercer and incorporated into the Investment Policy Statement. Thus the Board must (1) monitor and evaluate Morningstar, Mercer, and IMD, including the glidepath recommended by IMD and Mercer; and (2) approve the glidepath for GoalMaker (and any revisions to it).

Based on the recommendation of Slocum (an outside consultant) in 2015, the Board and the Department have pursued the potential of retaining an outside delegated investment manager as an option to develop and manage a custom glidepath for the NC 401(k) and NC 457 Plans. Pursuant to the Board's direction, IMD conducted an RFP and evaluation process to recommend a manager to the Board and at the last Investment Subcommittee meeting, presented a timeline for retaining such a manager and implementing a custom glidepath.

The Board, however, will be asked to discuss and consider a recommendation to continue offering a modified Morningstar glidepath as evaluated and recommended by IMD and Mercer, instead of continuing the process of retaining an investment manager to develop and manage a custom glidepath. In each alternative (delegation to an outside manager or recommendations from IMD and Mercer), the Board is relying on investment experts to develop a glidepath and is providing oversight of those professionals; as mentioned above, the Board is authorized and required to retain the services of experts in undertaking an issue of plan design, such as the development of a glidepath, that requires expertise beyond that of the Board's. Also, in both situations, the Board has the fiduciary duties of selecting the investment experts to develop the glidepath and monitoring and evaluating those experts and the glidepath on an ongoing basis.

The delegation to an outside investment manager would not require the Board to assume the responsibility of approving the actual glidepath; instead, the investment manager would have the authority to develop

and implement the glidepath. Retaining an outside delegated investment manager would take away some, but not all, of the monitoring responsibilities of the Board. Instead of relying on the expertise of IMD and Mercer, the Board would monitor the expertise of the outside investment manager.

The Board's focus should be on selecting the glidepath alternative that is in the best interests of the plans' participants, whether delegation to an outside manager, reliance on the recommendation of Mercer and IMD, or another option. In selecting the glidepath manager, the Board should engage in – and document – a process of due diligence, including the evaluation of the appropriateness of each alternative for participants, the expertise and resources of the Board and the Department, the expertise of Mercer and the delegated investment managers, and the expenses of each alternative – in terms of external management/advisory fees and the use of internal resources.

In addition, the Board should have a process to review and monitor the glidepath on an ongoing basis.