Performance dynamics driving fiduciaries to multimanager target-date funds

Todd J. Cassler
President of Financial Institutions and Advisory Solutions
John Hancock Investments

"It seems we've reached a tipping point: Not only do the majority of plan fiduciaries feel more comfortable recommending multimanager target-date funds, most say performance is the reason why."

Key takeaways

- In a recent survey of nearly 500 consultants, sponsors, and elite retirement plan advisors, the majority now prefers open-architecture, or multimanager, target-date funds. This portends a significant shift in plan design, given that less than a third of target-date funds employ an open-architecture approach today.
- Performance is the driving factor: Seven of 10 respondents who now use multimanager target-date funds do so because they believe these open-architecture structures offer the potential for better risk-adjusted returns.
- How do you define open architecture? Six in 10 surveyed insist that at least half of the underlying assets in a multimanager target-date fund must be run by unaffiliated managers.

Executive summary

Collaborating with *Pensions & Investments (P&I)*, John Hancock Investments commissioned a broad survey of retirement plan fiduciaries—including consultants, plan sponsors, elite defined contribution (DC) plan advisors, and other professional investors—to gauge views on retirement plan design in general, and target-date funds in particular. The findings represent a potential sea change for qualified default investment alternatives (QDIAs) in the future.

Combining affiliated and unaffiliated managers: a best practice for plan fiduciaries

In an industry that has embraced open-architecture retirement plan design for years, the composition of retirement plans' most important investment option—the target-date fund itself—has stubbornly stood out as a prominent exception.

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Our survey results suggest that attitudes toward target-date funds are changing among the key decision makers and influencers across the DC plan landscape. When asked directly about their preferences underpinning target-date fund construction, the majority of respondents indicated that they're now more comfortable using underlying investments that combine both affiliated and unaffiliated managers.

No plan advisor, consultant, or sponsor would doubt that devoting all assets to a single manager entails risks. That's why plan design best practices endeavor to combat manager concentration in participant portfolios by providing an unbundled menu of investment offerings, chosen for their merits, in managing specific asset classes. In fact, nonproprietary, or investment-only, options now represent most of the assets held in 401(k) plans today.[1]

However, multimanager target-date funds remain relatively rare. Only 31% of target-date fund providers have identified their offerings as purely open architecture.[2] Looking at assets under management is also telling. The three largest target-date fund providers—plan recordkeeping behemoths known for their proprietary offerings—enjoyed a 70% target-date mutual fund market share as recently as 2015.[3] In each case, the underlying funds were managed by affiliated companies.

But some of the recordkeepers committed to their single-manager offerings have begun to lose their lock on the target-date mutual fund market. Two of the three largest target-date fund providers saw their shares of the market erode in 2017.[4] Why? "As plans increase their target-date assets, it makes less sense to devote all assets to a single asset manager," in the words of one expert.[5]

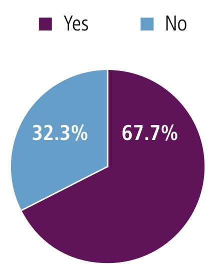
Based on the findings of the *P&I* survey, rising fiduciary standards throughout the industry, and increasing net flows into our own multimanager target-date funds, we expect this growing majority of fiduciaries advocating for open-architecture target-date funds to widen across the industry, into the foreseeable future.

Fiduciaries believe multimanager funds offer better risk-adjusted return potential

It seems we've reached a tipping point: Not only do the majority of fiduciaries feel more comfortable recommending multimanager target-date funds, most say performance is the reason why. Over two-thirds of respondents believe multimanager target-date fund structures offer the potential for better risk/return than single-manager funds.

Open architecture affords better performance prospects

Percentage breakdown of answers



Do you think multimanager structures offer the potential for better risk/return than traditional target-date funds?

Source: *Pensions & Investments*, John Hancock Investments, 2017.

This new feedback, directly from plan fiduciaries themselves, dovetails with earlier findings on views of target-date fund providers: "Participants benefit from asset manager diversification," said 75% of firms offering open-architecture target-date funds.[2] The U.S. Department of Labor (DOL), too, has highlighted the benefits of reduced manager concentration in target-date funds populated with multiple asset managers, "thus diversifying participants' exposure to one investment provider."[6]

Why is manager concentration a risk to participant portfolios? Academics studying organizational structure at investment firms have pointed to a strong link between hierarchy and herding, the tendency of portfolio managers to follow the trading behavior of their colleagues.[7] When all of a firm's portfolio managers rely on the same central research group, it's fair to question how they guard against groupthink.

Additionally, bringing together the expertise of unaffiliated managers from around the globe provides a broader range of potential investments for a participant's target-date fund. It's rare to find first-rate strategies across asset classes within one firm. It's equally rare to find top-notch offerings across substyles available within any given asset class. As portfolio management has become increasingly specialized, no single shop can expect to excel in every investment discipline needed for a truly diversified portfolio.

This is especially true for absolute return and other alternative investments lacking in most single-manager target-date funds. Relative to their long-run histories, today's low yields and high valuations suggest that mainstream U.S. markets may deliver below-average returns for the next decade or more. In such an environment, positions providing low or negative correlations with conventional security-price movements offer another source for returns and downside protection. Target-date funds that combine elite alternative managers with the most talented traditional managers may stand a better chance of meeting participants' retirement objectives in the years to come.

Multimanager target-date funds must have teeth to meet the term's purest definition

How open is open architecture? The synonymous terms *multimanager* and *open architecture* can have a range of different interpretations, depending on who's offering the definition. But if the question was put directly to plan fiduciaries right now, the consensus view makes a few things clear:

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A target-date fund with only a small sliver of underlying assets run by an outside firm is no longer sufficient to meet today's more demanding definition of a multimanager offering. In fact, 6 in 10 survey respondents insisted that at least half of the underlying assets in a multimanager offering must be run by unaffiliated managers.

This consensus from the plan advisors, consultants, and sponsors doesn't always line up with target-date fund providers' attempts to brand their suites as multimanager products. In fact, 17% of target-date providers that identify their offerings as open architecture state that their offerings allocate fewer than 25% of the assets to unaffiliated managers.[2] "Open-architecture target-date funds do not always diversify plan participants' exposure to a single manager to the degree that the open-architecture label suggest," warns one industry researcher. "It is important to look under the hood at the allocation range to non-affiliated asset managers."[2] In addition to supporting that conclusion, the overwhelming response reflected in our survey portends a sea change in target-date fund selection. Fiduciaries currently directing their participants to QDIAs dominated by manager concentration risk should take note.

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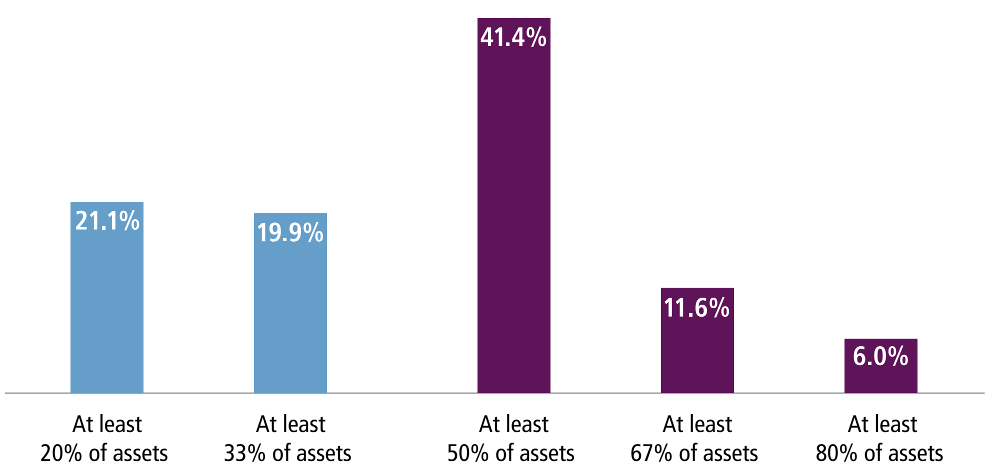
Percentage breakdown of answers



To fit your definition of a multimanager offering, what proportion of the assets must be run by managers unaffiliated with the product's sponsor?

Source: *Pensions & Investments*, John Hancock Investments, 2017.

The objective of this survey, jointly commissioned by *Pensions & Investments* and John Hancock Investments, was to collect opinions on defined contribution plan designs. By the survey's closing date of November 13, 2017, a total of 484 responses had been received. The findings of this survey may be accepted as accurate, at a 95% confidence level, within a sampling tolerance of approximately +/–4.5%.

1 *PLANSPONSOR, Pensions & Investments*, Cerulli Associates, 2016. **2** The Cerulli Edge, August 2016. **3** "Opportunities in Target Date Funds," Ignites Retirement Research, March 2016. **4** "Passive TDF Assets, Led by Vanguard's, Overtook Active in 2017," *Ignites*, 3/12/18. **5** "Record keepers lose hold on target-date offerings," *Pensions & Investments*, 10/17/16. **6** "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries," DOL, February 2013. **7** "The Role of Organizational Structure: Between Hierarchy and Specialization," Massa and Zhang, 2010.

Diversification does not guarantee a profit or eliminate the risk of a loss.

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