THE RETIREMENT INNOV8ION LAB

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Personalization in Workplace Retirement Plans: An Overview

By: Josh Anderson, CFA

Why personalization now?

How Americans prepare for retirement has evolved over time. Until the last 30 or so years, defined benefit plans were the main retirement plan offered by corporations to their employees. Employees could work hard and focus on their job and when it came time to retire, they were generally able to retain the same quality of life. Employees did not have to think about retirement plan contributions, investment returns, and ultimately the risk of successful outcomes because such factors were the responsibility of the employer. With the decline of defined benefit plans and the growth of defined contribution plans, this dynamic has changed drastically. These days, the risk of how much to save, how to invest, and ensuring successful investment outcomes is placed on employees, most of whom are likely neither knowledgeable about, nor confident about, making such decisions. According to the State of Money in America report conducted by Stash, “when it comes to making investment decisions, 13% of respondents said they feel very comfortable in their ability, and 41% said they feel somewhat confident.”[1] Meaning that nearly half of Americans are not confident in their ability to make investment decisions. Step on the floor of any workplace and this likely holds true. Too long has “set it and forget it” been the default advice to participants for their retirement accounts. The retirement plan represents the average American’s second largest asset.[2] For something so critical to their livelihood, participants do not want their unique needs to be devalued by a one-size-fits-all “set it and forget it” approach. Rather, participants are increasingly seeking individualized investment advice that is tailored to their particular circumstances.[3]

[1] Team Stash. *Stash*. 9 August 2022. <https://www.stash.com/learn/90-of-americans-want-to-invest-but-almost-half-dont-know-where-to-start/#:~:text=When%20it%20comes%20to%20making%20investment%20decisions%2C%2013%25,they%20are%20financially%20better%20off%20than%20their%20peers.>
[2] Franklin Templeton. "Voice of the American Worker." Research Study. 2022
[3] Franklin Templeton. "Voice of the American Worker." Research Study. 2022

Managed accounts in retirement plans represent a significant shift in the landscape of DC plan design. Personalized and professionally-managed advice has historically been cost prohibitive for most plans and participants. Competition has driven the cost of these services down, and some managed account offerings are now competitive with other plan investment alternatives, like Target Date Funds (TDFs). This evolution is likely to continue over the next decade and to redefine how a Qualified Default Investment Alternative (QDIA) is viewed by the retirement plan industry. Unlike traditional, one-size-fits-all retirement solutions, managed accounts offer a more personalized approach, tailoring investment strategies to the individual needs and circumstances of each plan participant. This introduction aims to provide a framework that can be used to explore managed accounts in greater depth. This white paper explores the structure, user interface, and technology and advice behind managed accounts. This analysis also compares the investment outcomes of managed accounts with traditional Target-Date Funds (TDFs).

1. Overview

Managed accounts in retirement plans generally utilize data received from the recordkeeper, as well as participant-provided inputs, to generate a more personalized portfolio customized to the participant's circumstances. They are designed to consider various factors such as an individual's age, retirement goals, risk tolerance, and other individual factors. There is an accelerating trend of personalized solutions being used as a QDIA due to the decreasing cost and ability to provide personalization beyond merely age. Participants are increasingly able to include additional personal factors like risk tolerance, assets outside of the plan, and income, to further individualize their needs and circumstances. Part 2 of this paper discussed the structure of the solutions and how different parts work together. Part 3 analyzes which parts of a managed account can be customized. Part 4 explores potential fiduciary risks specific to managed accounts and personalized TDFs. Part 5 reviews some of the more notable research on participant outcomes and pros and cons associated with managed account solutions. This paper also discusses research regarding whether participants are better off with more personalization.

Key Terms

Before we begin, it is helpful to explain some terminology. Below are a few of the key terms used throughout this paper:

- **User Interface (UI):** The UI is the platform through which participants interact with a managed account service. UI refers to the presentation of the platform, including the way participants view their balances, receive advice, and provide information, amongst other things. A well-designed UI is crucial for facilitating user engagement, understanding investment choices, tracking performance, and managing account settings.
- **Advice Engine:** At the heart of managed accounts is the advice engine – a combination of sophisticated algorithms and human input that provides personalized investment advice. This is what takes a participant's unique inputs and provides investment advice.
- **Strategic Asset Allocation**: Strategic asset allocation refers to the set of asset allocations used to fulfil the instructions provided by the advice engine. These can be created by an individual investment advisor or by the managed account provider.

- **Fiduciary Role:** Refers to the role the managed account provider is serving. Most frequently, a managed account serves as a discretionary asset manager to a participant's retirement account.
- **Portfolio Blending Methodology**: This is the methodology used to combine the advice from the investment engine and the strategic asset allocation into a portfolio specific to the participant.
- **Core vs Non-Core:** Core investment options are those designated investment alternatives that are available through the retirement plan's investment lineup. Managed accounts that use the core lineup create participants portfolios using the funds available to participants. A managed account that uses non-core funds create participant portfolios using investments that are walled off from direct access by participants.
- **Input Factors**: Refer to the individual's data points that are provided by the plan's recordkeeper or a participant. They include variables like age, income, risk tolerance, financial goals, and other personal circumstances that are considered by the advice engine.
- **Outside Accounts**: These are assets or income sources that are not part of the retirement plan but are factored into the advice provided through the managed account.
- **Middleware**: Refers to a firm that provides technology services and acts as a conduit between the recordkeeper and managed account advice engine. Middleware typically includes the user interface (UI).

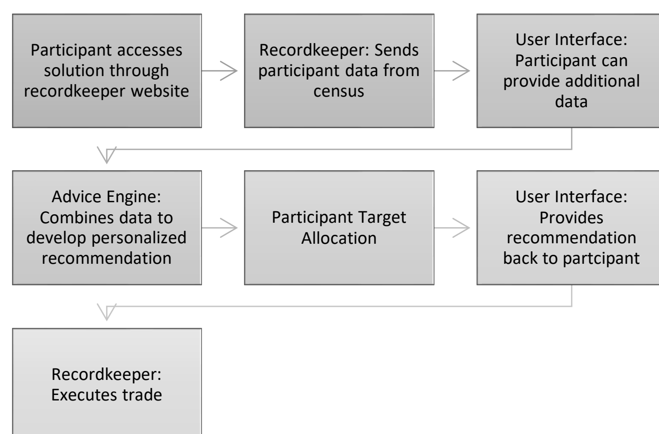
2. Structure

One likely contributor to the slower adoption of managed accounts relative to TDFs is their more complicated structure and the challenges in conveying the structure to participants. While there is significant variation amongst the different providers, there are four main components of any managed account —user interface, advice engine, strategic asset allocation, and portfolio investments.

The user interface (UI) is the point of human-computer interaction and communication in the managed account platform. It is how the participant interacts with the advice engine. This is where participants engage with the program, including accessing their accounts and records, and provide additional data inputs like risk tolerance or outside assets. The UI is the driver behind better participant engagement, which is likely the single largest factor in an individual recognizing the benefits of managed accounts. This concept is discussed in greater detail in Section 5 below.

An advice engine takes the various participant inputs and uses them to provide a personalized portfolio. The two most common approaches that any advice engine uses are goals-based and risk-based. Nearly all providers use Monte Carlo simulations to determine the portfolio to be assigned to a participant. The simulation is periodically rerun to help the participant stay on track or make any necessary portfolio changes. [The Monte Carlo simulation is a mathematical technique that predicts possible outcomes of an uncertain event.]

The strategic asset allocation (SAA) is the range of model portfolios or asset allocations that the advice engine uses to create each unique participant portfolio. They typically are spread across the risk spectrum with the most conservative and aggressive allocations representing that minimum and maximum risk available to a participant. This can help participants improve diversification. Some advice engines will blend multiple SAAs to create hundreds of possible portfolios, while others use a single portfolio to achieve their goals.



Portfolio investments used by a managed account offering can be funds that are in the plan's lineup (core) or funds selected for exclusive use in the managed account (non-core). The benefits of using the core lineup are that the core designated investment alternative have been pre-vetted by an investment fiduciary to the plan, who has already done extensive due diligence on the investments, and the designated investment alternative are likely diversified among various investment managers. This is generally not the case with respect to the funds used as building blocks in TDFs. Non-core funds could allow the inclusion of more unique asset classes, such as alternatives or in-plan annuities.

The client journey and experience vary depending on whether the managed account solution is used as a plan's QDIA. Naturally, more personalization will occur with an engaged participant. Nevertheless, there are several participant data points available without participant engagement in a QDIA scenario. When used as a QDIA, the recordkeeper will provide basic participant data inputs to the middleware/advice engine. The advice engine takes these inputs and determines the appropriate portfolio for that individual. Depending on the solution and the portfolio blending methodology, the middleware and/or advice engine will provide the individual's specific portfolio to the recordkeeper, who then executes the trades. This process usually takes place automatically with minimal human input after the initial setup. The inputs that are most common in a QDIA scenario are age, salary, deferral rate, current balance, location, and sex. With these inputs, multiple other factors can be calculated. For instance, location can inform the tax rate implications, and age and sex can inform longevity implications. Salary can be used to infer an income replacement goal and tax implications.

When a participant engages and provides additional information about themselves, the engine can provide a greater level of personalization using these new data points. Naturally, this means the service improves with the input of additional information. Engagement also provides a feedback loop that guides the participant towards better behaviors that improve outcomes. While potential inputs vary across solutions and recordkeepers the most common are:

- **Outside Assets**: Nearly all managed account solutions can factor in outside assets. However, the way the information is incorporated varies among managed account programs. Advanced solutions can view the actual underlying holdings and use the expected returns for such assets. Other solutions merely take the account balance and apply a standard rate of return. The way the participant enters the information can vary depending on the solution. Many providers offer integration through a third party (like Plaid or MX), which allows ongoing

access to each account. Some only offer a static manual entry of each account. For a subset of participants, the ability to include outside assets is critical to receiving holistic and accurate advice. Take the situation of a new executive to a company. The executive likely has a high income and significant outside assets with previous employers' retirement plans. Without engagement, the advice engine would view only the high income and low balance, likely placing the executive in an aggressive allocation. However, this would likely not be appropriate, assuming the executive was on track with their other assets.

- **Householding/Spousal Information:** Many solutions offer ways to include spousal information that factors into the advice generated by the engine. This often allows the inclusion of spousal assets, like retirement plans, brokerage accounts, annuities, etc. to be included in the advice provided within the retirement plan account. This can be an important factor in ensuring accurate and holistic advice. Take the instance of a married couple where one has a high income and large 401(k) balance and the other a low income and smaller retirement account balance. Without the inclusion of spousal information, the low-income earner would likely receive a portfolio that is not appropriate for their actual situation.
- **Risk Tolerance:** The ability to provide input regarding risk tolerance is universally offered. However, the sophistication varies from provider to provider. In some cases, this can even be customized with a firm's risk tolerance questionnaire. The more advanced managed account options have a multiple question process that balances both risk capacity (ones actual ability to take risk based on their situation) and risk tolerance (ones comfortability with taking risk). The less advanced managed account options use a single question that merely asks about risk tolerance.

3. Customization

Managed accounts have historically been very limited in their ability to add customization or advisor input. However, over the past few years, there has been an expansion in the ways advisors can customize managed accounts. This trend has been led by Morningstar. Many new entrants into the managed account provider market are seeking to expand on the ways advisors and home offices can customize a solution for their needs. Depending on whether the advisor or their home office is establishing the solution, different levels of personalization exist. This is partially due to the cost and technical resources required to set up a custom version. It is also notable that, within a managed account solution, there is almost always variation in availability from recordkeeper to recordkeeper. For example, an advisor may be able to use their firm's customized strategic asset allocations (SAAs) in a firm branded managed account with one recordkeeper. However, other recordkeepers may not provide the ability to use custom SAAs, and therefore, only standard allocations are available.

The most common aspects that advisors can customize are branding, strategic asset allocations, and funds used to construct SAA models. Nearly all providers offer this level of customization with options to outsource aspects that the advisor or home office chooses. Less common components that can be customized are the risk questionnaire, UI, engagement tools that help the advisor find wealth prospects, and financial wellness programs. When customized or white labeled for the advisor, these solutions are commonly referred to as Advisor Managed Accounts (AMA). Numerous investment advisers and broker-dealers have launched their own AMA with varying degrees of customization. Others have chosen to fully customize and take responsibility for the SAAs, branding, fund lineup, and even some incorporating their own proprietary investor profiling process. When considering the levels of customization and roles to serve, it is critical to understand the fiduciary liability that may come with each decision. For example, a common scenario is that the managed account may act as a discretionary investment manager to the participant, and the advisor provides SAAs and the fund lineup. Without a clear understanding of the services provided and roles that each party has, this may create shared liability and cause the advisor to unknowingly take on risk.

	Personalized TDF	Managed Account	Advisor Managed Account
Advisor branded UI	No	No	Yes
Strategic Asset Allocation/Models	No	Varies	Yes
Fund Selection	No	Yes	Yes

4. Fiduciary Considerations

There are fiduciary considerations surrounding managed accounts that are frequently raised by financial advisors, home offices, and their attorneys. Four of the largest concerns are: the fiduciary role a provider serves (if any), structure of advisor compensation, overall appropriateness in the context of the Employee Retirement Income Security Act (ERISA), and cost.

First, it's essential to recognize the role the managed account provider plays to the plan or participant. In most cases, providers act as a discretionary fiduciary (commonly known as a 3(38) fiduciary) to the participant, offering discretionary management of assets. Some service providers may also act as a 3(38) fiduciary to the plan by selecting the designated investment alternative in the plan's core investment lineup. However, other arrangements might be non-discretionary, in which the participant receives one-time or ongoing investment recommendations. This can get further complicated by AMA solutions where the advisory firm takes an active role in design aspects like CMEs, SAAs, and glide path design. Understanding each stakeholder's role in these complex solutions is a critical part of the due diligence process.

Another consideration lies in the structure of compensation. Different compensation models can give rise to concerns around conflict of interest. For instance, if an advisor receives an additional fee tied to the assets in the managed account, it may influence a recommendation to use the service, potentially at the expense of a participant's best interests. One structure that addresses this concern is for the advisor not to charge an additional fee on the managed account, but rather to include it in a "premium" service offering. For example, assume an advisor's standard offering includes plan consulting, and they act as the 3(38) fiduciary to the plan lineup. They could offer a "premium" offering at a higher fee which includes the additional participant advice and participant-level 3(38) fiduciary services. Since the fee is charged across the plan as a flat fee or percentage of plan assets, the potential conflict of interest associated with a fee directly tied to managed account assets is eliminated. This scenario demonstrates the complexities of these solutions and the need for transparency and alignment of advisor-client interests.

The concept of reasonableness of fees under the ERISA must be carefully considered. The 2013 Department of Labor (DOL) guidance titled *Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries,* while written when TDFs were gaining steam, gives us a roadmap for consideration of

managed accounts as a QDIA. The DOL guidance indicates that fiduciaries should consider traditional factors like performance and fees, but also "how well the QDIAs characteristics align with eligible employees' ages and likely retirement dates," and the "possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns."[4] Given that the design of managed accounts includes multiple factors as described above, one could infer that managed accounts better meet this DOL guidance than a TDF could, given the limitations of the TDF design. The DOL guidance goes on to encourage the evaluation of custom and non-proprietary offerings by providing, "Alternatively, a 'custom' TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF. Non-proprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider."[5] It is notable that the DOL refers to inclusion of the core funds in the QDIA and using multiple fund managers as an "advantage." These benefits should be weighed for the value delivered relative to the cost of each solution.

Managed account costs have, until recently, generally been too high for most fiduciaries to justify as a QDIA. In the last few years, new entrants and increasing competition have reduced managed account costs to be competitive with active (and some blended) TDFs. For instance, multiple managed account solutions are offered at 10 bps or less. Assuming a blended active/passive portfolio expense between 20-30 bps, the total cost to a participant could be 30-40 bps.[6] For context in 2022 average prospectus-adjusted net expense ratio for active TDFs was 82 bps; blend 61 bps; and passive 27 bps.[7]

Fiduciaries should assess whether a managed account service provides value commensurate with cost, ensuring that the fees charged are reasonable considering the services rendered. This evaluation should consider the holistic benefits to the participant, including investment management, customization, and potentially, financial planning and advice. It is also advisable to consult a knowledgeable consultant and ERISA attorney to discuss legal and regulatory specifics.

[4] US Department of Labor. "US Department of Labor." June 2013
[5] US Department of Labor. "US Department of Labor." June 2013
[6] Investments: 20-30 bps + Technology: 10 bps
[7] *Target-Date Strategy Landscape: 2023*. Inustry Report. Chicago: Morningstar, 2023

5. Outcomes Through Managed Accounts

The adoption of managed accounts in retirement strategies is often tempered by uncertainties about their effectiveness compared to traditional target date funds (TDFs). This section aims to provide a balanced analysis of the efficacy and challenges of managed accounts. This section synthesizes key findings from prominent studies to offer a comprehensive perspective on the strengths and weaknesses of managed accounts in 401(k) plans.

Advantages of Managed Accounts:

1. Customized Investment Strategies: The defining aspect of managed accounts is their customization capabilities. Aligned with each participants' unique financial goals and risk appetites, these accounts create portfolios that encourage resilience during market turbulence. A study by Alight spanning 2006-2016 highlights a substantial contrast in the lapse rates between managed accounts (26%) and TDFs (67%), illustrating a more stable participant engagement in managed accounts, which also yielded better long-term returns.[8]
2. Boosting Savings Rates: A 2022 Morningstar report revealed that managed accounts significantly influence participants to increase their savings rates, particularly those previously falling short of their retirement goals.[9]
3. Diversification Benefits: Managed accounts promote a balanced risk management approach. A report by Alight confirms that managed account users show a more diverse asset allocation compared to TDF users or non-participants, leading to a more robust investment strategy.[10]
4. Expansive Financial Planning: Beyond investment guidance, managed accounts offer comprehensive financial planning advice. Morningstar's 2022 findings underscore the positive impact of managed accounts on participants' savings behaviors and retirement preparedness.[11]

[8] Alight Solutions. "Impact of managed accounts and target date funds on DC plans." 2018
[9] *The Impact of Managed Accounts on Participant Savings* . Research. Chicago: Morningstar, 2022. PDF. December 2023
[10] Alight Solutions. "Impact of managed accounts and target date funds on DC plans." 2018
[11] *The Impact of Managed Accounts on Participant Savings* . Research. Chicago: Morningstar, 2022. PDF. December 2023

5. Fee Considerations: While offering several benefits, managed accounts typically involve higher fees. It is worth noting that the U.S. Government Accountability Office reports that despite higher costs, managed account participants could see substantially better performance net of fees.[12]

Challenges of Managed Accounts:

1. Complexity: The intricate nature of managed accounts can overwhelm advisors, plan committees, and participants, potentially leading to reticence to consider a managed account offering for a plan, misunderstandings, or less engagement.
2. Varied Impact: The effectiveness of managed accounts can differ based on an individual's existing factors. Morningstar's research indicates that the primary advantages of managed accounts are derived from behavioral changes rather than direct investment performance.[13]
3. Assessment Challenges: The lack of standardized benchmarks complicates the evaluation of managed accounts, especially when compared to TDFs.
4. Performance Comparison Issues: Directly comparing the performance of managed accounts to TDFs is difficult due to their personalized nature. Moreover, such a comparison is not accurate, as a managed account is generally not analogous to a TDF. An integrated approach to analysis is essential to fully understand their value.
5. Security and Privacy Concerns: In an increasingly digital world, the need for sharing personal financial information in managed accounts raises data security and privacy issues.
6. Potential Conflicts of Interest: The structure of advisor compensation and other elements in the managed account delivery chain can present conflicts of interest that require careful management and disclosure.

[12] United States Government Accountability Office. *Improvements Can Be Made to Better Protect Participants in Managed Accounts*. Report to the Ranking Member, Committee on Education and the Workforce, House of Representatives. Washington DC: United States Government Accountability Office, 2014.
[13] Morningstar Investment Management LLC. *How Managed Accounts Can Help Employees Save and Invest for Retirement*. Research. Chicago: Morningstar, 2019

Conclusion

Managed accounts provide a personalized approach to investment and financial planning, potentially leading to more favorable financial outcomes. However, their benefits must be weighed against challenges like higher fees and greater complexity. Retirement plan advisors and decision-makers need to balance these factors to ensure a suitable and effective solution is selected.

Future Considerations

As personalized financial strategies gain prominence, staying informed and skilled in this area becomes crucial for advisors. Reflect on these guiding questions to shape your approach to incorporating managed accounts:

1) How active do I want to be in the ongoing management of the solution?
2) What is my primary reason for considering managed accounts?
3) How much responsibility or liability am I willing to accept?
4) Which liabilities and risks am I willing to take?
5) Which recordkeepers do I want to use?
6) Which areas do I need to customize?
7) Which areas do I want to customize?
8) How do I want to get paid (if at all)?

Feel free to reach out at Josh@innov8ionlab.com to discuss your responses or for guidance with evaluating a personalized solution that aligns with your goals.

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