Illinois Secure Choice

Proposed Fund Structure and Next Steps

Segal Marco Advisors

Overview

- Structural issues
  - Type of funds
  - Number of funds
  - Target Risk versus Target Date
- Segal Marco review of Target Risk Fund Options
- Segal Marco recommendations and suggested next steps.

Target Risk Fund Screens

- Universe Screens
  - Investment Metrics
    - 1,608 Balanced Fund Options
  - eVestment Alliance
    - 1,163 Balanced Fund Options
  - Morningstar
    - 2,139 Balanced Fund Options
- Results
  - Applying a 20 basis point maximum fees, only a handful still offer traditional target-risk balanced funds
    - At 15 basis points, we get none
      - Most balanced funds (ex TDFs) are actively managed, and therefore too expensive
      - Many former providers of Target Risk Funds – including previous market leaders SSgA and Blackrock – no longer offer this strategies within a ’40 Act Mutual Fund format
        - Tide has dramatically shifted towards Target Date Funds
  - Other managers may be able to offer strategies that meet our objectives
    - But do not may not have a live track record
    - Ex. Dimensional Fund Advisors, Vanguard

Target Risk versus Target Date Funds

- Target Risk Funds used to dominate defined contribution plans
  - Both as default option as well as satellite options
  - Benefits included
    - Broad diversification
    - Smoother return stream than underlying asset components
  - Having a range of target risk funds can allow investors to further fine tune their investment exposures
    - Without as much single-beta risk as would come from an S&P 500 fund, for example
- Target Date Funds have largely supplanted Target Risk Funds
  - Not completely, but very few DC plans have both TDF and TRF options
    - Target Date Funds considered Qualified Default Investment Option by DOL
    - Target Date Funds help address the evolving risk profile of maturing investors
    - Having both TDFs and TRFs tends to generate confusion
      - Perceived overlap, often with no clearly defined role for one versus the other
      - This can be mitigated by clear and effective communication
  - Where both exist, Target Date Funds dominate fund inflows
    - Most Target Risk Funds where Target Date Funds also exist are offered as “satellites”, not default investments

Use of Target Risk Funds versus Single Strategy Funds

- Target Risk Funds have superior diversification characteristics over single strategy funds
  - Smoother return stream (usually) than individual asset classes can help investors from being whipsawed (and buying high/selling low)
  - Improved diversification means fewer moving parts in investor portfolio (simple)
- Target Risk Funds are generally more expensive than SSFs
  - Additionally, the clear majority are actively managed (definitionally higher fees)
  - May be difficult or impossible to work within existing Secure Choice fee limits

Segal Marco Observations on Target Risk Funds

- Target Risk Funds may be a potential candidate for an expanded fund line-up after successful program launch
  - Simplicity is important, especially at outset
  - Once participants have broad familiarity with the program, it may make sense to offer additional customization and fund options like Target Risk
  - We suspect the overall demand for Target Risk Funds will be low
    - Based on real-world experience with other Segal Marco clients
    - Certainly much lower than Target Date Fund demand
    - Comparable to demand for Single Strategy Funds based on client experience
  - Perhaps investor surveys can be used to gauge potential demand within Illinois for Target Risk Funds

Summary, Recommendations and Next Steps

- With respect to structure, Segal recommends that the program start off with
  - Target Date Funds
  - Single Strategy Funds
    - S&P 500 Index Fund (aggressive option)
    - Core Fixed Income Index Fund
    - Short-Term/Money Market Fund (exact contours to be decided)
  - Additional strategies could be considered down the road
    - But costs and a strong desire to simplicity suggesting starting here
    - Spans the range of risk
    - Provides most of the broad market exposures
    - Does so inexpensively

Summary of Proposed Investments

Fund Type	Risk Profile	Objective	Notes
Target Date Fund Series	Up to 12 vintages spanning the risk spectrum from conservative to aggressive. Risk levels are calibrated to match risk tolerance levels in savers according to their number of years from retirement.	To provide easy “set it and forget it” glide path that fits most investors’ life cycles.	Using passive strategies, costs are very, very low. Target Date Funds are now almost always the “core” (QDIA) of a savings or defined contribution program.
S&P 500 Index Fund	On the aggressive end of the spectrum (but not as aggressive as small cap or emerging markets equities, as two examples).	To provide investors seeking long-term capital appreciation the lowest possible cost way to benefit from the growth in the US economy and stock market.	Another core component of the vast majority of savings and defined contribution plans. Used to be part of the “safe harbor” under ERISA before Target Date Funds were introduced

Summary of Proposed Investments

Fund Type	Risk Profile	Objective	Notes
U.S. Core Bond Index Fund	On the low to moderate end of the risk spectrum. Offers higher yield and return potential than money market funds, but with the risk of capital losses in the event of rising interest rates.	To provide investors seeking income and/or a relatively low risk investment with the lowest possible cost way to potentially hedge their stock market exposure, or just earn modest (but still positive) yields on their savings.	Like S&P 500 funds, Core Bond funds are a staple of most savings and defined contribution plans. And as with S&P 500 funds, they were previously considered to be "safe harbor" investments before Target Date Funds were introduced.
U.S. Prime Money Market Fund or equivalent	The very lowest possible risk in an investment, but at current low yields, with very little potential for meaningful income and no appreciation potential.	Meant for investors looking for an absolute store of money that will not lose value, even if it will not earn meaningfully positive returns.	Virtually all savings and defined contribution programs offer a type of money market fund. Increasingly, many are government only, but these offer lower yields than so-called Prime money market funds, which can invest in corporate debt, as well.