Making the Case for Managed Accounts

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Many plan participants are failing to reach their retirement income goals, mostly because they lack the time, knowledge, and interest to setup, manage, and oversee their retirement accounts. Many also make poor investment decisions, such as allocating too much to one fund, overexposing, or underexposing their accounts to equities, making pre-retirement withdrawals, or failing to increase their contributions over time.

The end result is perhaps best summed up by a recent headline in The Washington Post, “Many Americans Will Run Short in Retirement.” The headline was based on a July 2010 study by the Employee Benefit Research Institute, which found that a significant number of US workers are going to find it challenging to meet even basic expenses in retirement.

To determine how Morningstar Associates’ managed accounts are helping participants avoid such adverse outcomes, we conducted a case study in 2011 of 1,195 participants enrolled in our advisory service. That group represented participants who had enrolled in our managed accounts service through our online web site as of November 2010. While more than 90,000 participants are enrolled in our managed accounts service, the study was limited to online enrollees because we don’t always capture or save information about a participant’s current strategy if they enroll over the phone, through our paper enrollment process, or through a batch-enrollment process. In the batch-enrollment process, the plan provider sends us a file with a limited range of data points—enough to generate an investment recommendation but not enough to be included in a detailed comparative study. As a result, we have no way of knowing whether these participants experienced the same kinds of results as those featured in this study.

Our most significant finding was that participants who enroll in our service have, on average, 19% more projected annual retirement income if they follow our recommended strategies. For the average American, that would translate into an increase of about $5,467 (this is based on a July 2010 report by the Employee Benefit Research Institute that found that the average income of those age 65 and older in 2008 was $28,778—the most recent year for this statistic).

A number of factors are driving this result. Specifically, plan participants who enrolled in our managed accounts are:

- better diversified
- more appropriately allocated based on their risk level and time horizon
- invested in what Morningstar Associates believes are the highest-quality funds in their plans’ lineups
- being encouraged to increase their contribution rates

• Participants enrolled in our managed account service will see, on average, a **19% increase in projected annual retirement income**.

• Our 60/40 managed accounts **portfolios outperformed the S&P 500 by 6%** from January 2008 to December 2010.

• **62% of participants weren’t properly allocated** before enrolling.

• **49% of participants had more than 30% of their accounts allocated to a single investment** before enrolling.

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1Participants enrolled in a target-date fund or other asset allocation fund were excluded from this result.
Selecting the Right Funds

When participants enroll in our managed accounts service we present them with an asset allocation strategy that is tailored to their specific situation and risk-tolerance level. We then construct their portfolios using what we believe are the highest-quality and most appropriate funds from a plan’s lineup. In building portfolios for our institutional clients, we have found that fund manager quality—as well as how funds work in combination—can have a quantifiable impact on long-term portfolio performance. For instance, as illustrated in the chart below, during the trailing five-year period ending March 2011, the top-decile funds in the Morningstar large-cap category gained 30.69% more on a cumulative basis than the bottom-decile funds2. That’s a sizeable performance differential.

**Difference in returns between top and bottom decile managers**

<table>
<thead>
<tr>
<th>Category</th>
<th>10th Percentile</th>
<th>90th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>32.72%</td>
<td>2.03%</td>
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<tr>
<td>Mid</td>
<td>35.53%</td>
<td>9.39%</td>
</tr>
<tr>
<td>Small</td>
<td>39.96%</td>
<td>3.28%</td>
</tr>
</tbody>
</table>

The findings from our case studies support our belief that plan participants, although limited to choosing the funds that are made available to them by their plan, can still position themselves to capture outperformance by selecting higher quality funds. By high quality, we mean funds that have experienced managers at the helm, strong track records of success, and clear, well thought-out investment processes.

In our case study, we found that if a participant in our managed accounts service was allocated to a balanced 60/40 portfolio in which we selected the underlying funds, they would have, on average, earned an annualized three-year return of about 3.34%, net of fees, as of December 2010. If they had invested in a fund that tracked the performance of the S&P 500 index during that same period, they actually would have lost money with a -2.86% annualized return.

Meanwhile, we found that if a participant had invested in a portfolio that tracked to Morningstar Moderate Allocation Category3 from December 2007 to December 2010, they would have earned just 0.16%, net of fees. That means that a balanced portfolio for which we selected the underlying funds outperformed the S&P 500 by more than 6% and the Morningstar Moderate Allocation Category by more than 3% on an annualized basis.

To measure the performance of a managed accounts portfolio, we took the weighted average annualized returns over a three-year period (January 2008 to December 2010) of every fund we selected for inclusion in the 60/40 portfolios used by plan sponsors that offered our managed accounts service during that entire three-year period (we excluded any plans that offered custom funds or obsolete funds). We compounded those weighted average quarterly returns (to replicate quarterly rebalancing) then calculated an annualized three-year return. We included multiple share classes when we had selected more than one share class for a fund. In determining the average portfolio returns, we assumed the following category weights: 26% for US large cap; 8% for US mid cap; 3% for US small cap; 9% for international large cap; 3% for international small cap; 4% for diversified emerging markets; 2% for real estate; 25% for intermediate bond; 8% for inflation-protected bond; 3% for high yield; and 9% World Bond. For stable value and money market returns, we used the proxy return of the BarCap Stable Value Benchmark TR USD.

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2Data represents the difference between five-year cumulative returns of the top decile and bottom decile funds in three Morningstar, Inc. mutual fund categories as of March 2011. Categories shown were selected to illustrate concept.

3The Morningstar Moderate Allocation Category is broadly diversified across stocks, bonds, and cash. Funds that fall into this category typically have 50% to 70% of their assets in equities and the rest in fixed income and cash.
Diversifying Toward Success

In order for participants to reach their retirement income goals, they need to have the most appropriate and most efficient asset allocation mixes for their specific risk levels, retirement income objectives, and time horizons to retirement. Most participants, though, are either assuming too much risk or not enough risk, and many are too heavily allocated to one specific fund. In determining the degree of improvement in the allocation strategies of managed accounts participants, we examined the equity allocations of the 1,195 participants before they implemented our recommendations. Participants with equity allocations that were +/-10% of our recommendations were deemed to be improperly allocated.

We found that almost 62% of participants weren’t properly allocated before enrolling in our service. Some were too aggressively allocated and some were too conservative in their approach. Additionally, many were significantly under-diversified—49% of participants had more than 30% of their retirement account allocated to a single investment vehicle before enrolling in our service; 37% had over 40% of their retirement account allocated to one fund; and 31% had over 50% of their retirement account allocated to one fund. These results excluded participants who were invested in target date or asset allocation funds.

- 49% of participants had more than 30% of their retirement account allocated to a single investment vehicle before enrolling.
- 37% had more than 40% of their retirement account allocated to one fund.
- 31% had more than 50% of their retirement account allocated to one fund.

We also found that before enrolling in our services, more than a third of participants were overexposed to equities based on their specific risk tolerance levels, time horizons, and retirement objectives. More specifically, we found that 34% of participants were too aggressively allocated before enrolling in our service (and 28.5% were too conservatively allocated). We define “aggressive” as being those whose equity allocations were at least 10% higher than our recommended targets, which are designed to help reduce the investor’s risk of sustaining significant losses during a market downturn.

- 34% of participants were too aggressively allocated before enrolling.
- 29% were too conservatively allocated.

To determine the most appropriate equity exposure for a managed accounts user, we first determine the number of years they have until retirement. We then use an asset/liability model to evaluate the participant’s capacity for assuming risk. Possible assets include such things as current balances in retirement accounts, the streams of future savings to retirement accounts, projected Social Security benefits, and other future cash inflows. Participants can fine-tune their customized asset allocation mix by taking an optional risk-tolerance questionnaire. Based on their appetite for risk, we might adjust their equity exposure by +/-10%. In addition, we examine the asset mix of any retirement assets held outside of the plan and adjust our recommendations accordingly so that the participant isn’t overexposed or underexposed in any one specific area.
Case Study Results

The importance of addressing risk—specifically downside risk—is perhaps best illustrated by the damage that occurred to participants’ retirement accounts during the 2008 market crisis. According to the Congressional Budget Office, that market decline wiped out about $2 trillion in retirement savings in a 15-month period starting in 2008. Although it was impossible for participants to avoid sustaining investment losses during that period, we believe most could have cushioned the blow by having an appropriately diversified portfolio that considered downside risk.

Preserving wealth in bull and bear markets

Stocks, bonds and diversification: 2002-2009

Diversification helps an investor reduce volatility in his or her retirement portfolio. During market upswings, though, a diversified investor may not realize the higher returns of an aggressive, all-stock portfolio, but in a downturn, they won’t lose as much. The end result, as you can see from these charts, is a much smoother return profile and reduced downside risk.

Encouraging Increases in Savings Rates

Less than half of workers have taken steps to calculate how much they need to be saving today in order to live comfortably in retirement, according to the Employee Benefit Research Institute. As a result, participants aren’t sure how much they should be saving, although this is the area where they have the greatest control. In fact, according to the Profit Sharing Council of America’s 52nd Annual Survey, participants are only saving up to 3% of their plan’s default contribution rate.

Every participant who enrolls in our managed accounts service is presented with a gap analysis that shows the impact that even a small increase in savings can have on their retirement income outlook. With a better understanding of the importance of saving more, we have found that participants are more likely to take action. Our managed accounts service encourages participants to increase their contributions to their retirement accounts by at least 2%. It also encourages them to save to at least the point where they receive the full employer match, if such a benefit exists.
The solution is for plan providers and sponsors to improve or enhance the resources and services that they are making available to participants so participants can make smarter and more informed investment decisions.

**Conclusion**

Industry-wide, it is clear that most plan participants are failing to reach their retirement income goals because they are making poor investment and savings decisions. That isn’t the fault of participants, as few have access to the resources needed to construct and maintain a viable investment strategy for their retirement portfolios. Many, for example, don’t know what the most appropriate asset allocation should be for their specific situation, risk level, and time horizon. Additionally, most don’t know how to select the right combination of funds that will help them hit their asset targets and that will have the greatest potential to drive excess returns. And lastly, many don’t know how much wealth they will need to amass in order to achieve a comfortable retirement. Absent a clear income goal, participants have a difficult time setting and maintaining a disciplined savings strategy.

The solution is for plan providers and sponsors to improve or enhance the resources and services that they are making available to participants so participants can make smarter and more informed investment decisions. Those investment services and resources need to be grounded in sound, objective advice, and need to help participants construct tailored investment strategies that will deliver results in a variety of different markets, and will address their specific risk levels, time horizons, and objectives.
About Our Advisory Services

Our advisory service—Morningstar® Retirement Manager™—provides participants with a personalized retirement strategy intended to help them reach their retirement income goals. Participants can receive recommendations for their contribution rates, asset mixes, and investment selections. To address the broad needs of a company’s employee base, Morningstar Associates offers two service options: managed accounts and advice.

Managed Accounts (Managed by Morningstar)

With the managed accounts service, the participant assigns to Morningstar Associates the responsibility for managing their retirement plan assets. Incorporating personal information about each participant, we use our fund selection and asset allocation expertise to create individual, diversified retirement portfolios from the investment options available in the plan. On a quarterly basis, Morningstar Associates reviews the participants’ portfolios and rebalances each account as necessary. This solution is ideally suited for those who don’t have the time, interest or knowledge to manage their retirement accounts on their own.

Advice (Managed by You)

Our advice service allows participants to explore the underlying assumptions of their personalized retirement strategy recommendations and provides point-in-time recommendations. With Managed by You, the participant assumes responsibility for implementing the recommendations and rebalancing and managing their accounts on an ongoing basis. This solution is ideally suited for those who prefer to take an active role in managing their retirement accounts.

About Us

Morningstar Associates is a registered investment advisor and part of Morningstar Investment Management, a division of Morningstar, Inc. That division also includes Morningstar Investment Services, Inc., and Ibbotson Associates, Inc., both of which are registered investment advisors and wholly owned subsidiaries of Morningstar, Inc. Combined the group advises on $130 billion in assets as of Dec. 31, 2010, and its services are made available to 23.5 million plan participants through 150,000 plan sponsors and 23 plan providers. The group offers a suite of retirement solutions, including custom target maturity funds, managed accounts, lifetime financial advice, and plan sponsor advice.