Defined Contribution

March 2019

Reinventing the DC Core Menu with Pre-Retirees in Mind

Despite the surge of new flows into the default investment, over 70% of the $2 trillion in existing Defined Contribution (DC) plan assets still reside in the core menu.[1]

Many of the participants invested in the core are older, as reflected by the stratification of assets featured in Figure 1. While this trend may be attributable to older workers' inertia — and new hires' gravitation to the default — some participants over age 50 may also be constructing portfolios from the core menu to more suitably address their specific, and increasingly complex, financial needs as they near retirement.

Figure 1
Examining the Core Through a Demographic Lens

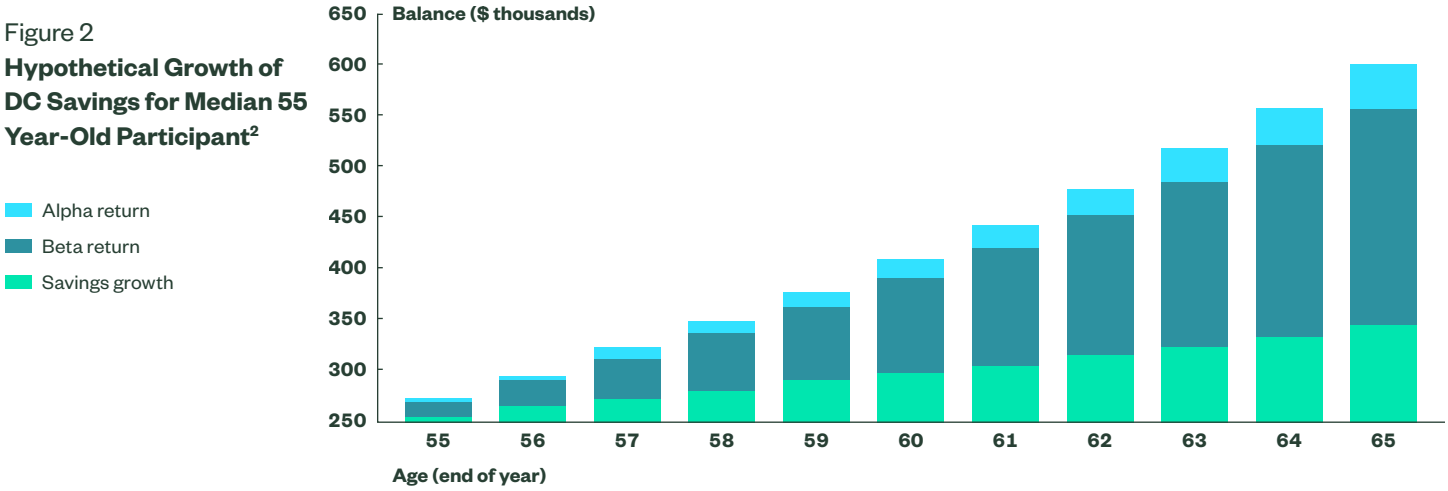
Age	20s	30s	40s	50s	60s
% of DC AUM in the core menu Conversely, % of DC assets NOT in TDFs and balanced funds	45.4%	62.0%	72.4%	75.4%	75.8%

Source: Employee Benefit Research Institute.

Because those closest to retirement are those with the greatest concentration of assets in the core, the investment approach to menu management must be deft. Instead of feverishly chasing alpha — which could introduce more risk than a near-retiree could absorb — managers must take a more measured approach, stalking returns strategically.

We will also make the case that active management can play an important role in providing participants with meaningful levels of real income replacement in retirement. But not all asset classes merit an active approach, and not all active approaches are similar. Sponsors must be prudent in choosing where to implement active management, and carefully evaluate the types of alpha-seeking behavior that the chosen managers employ.

Figure 2
Hypothetical Growth of DC Savings for Median 55 Year-Old Participant[2]



Here, we will focus on three asset classes that merit inclusion in DC investment menus, each of which can serve a specific purpose to meet the demands of mature savers within the core menu.

1. Global Defensive Equity for downside protection
2. Emerging Markets Enhanced for return consistency
3. Real Assets for inflation dampening

Global Defensive Equity

Alpha Through Downside Protection

Losing less in market downturns leads to outperformance over time, and outperformance through downside protection is specifically aligned with the objectives of older investors. Simply holding low beta stocks can often lead to underperformance in strong equity markets. A strategy that can consistently protect on the downside while being mindful of valuation has the potential to add meaningful alpha across a full market cycle. This equation could play a key role in any near-retiree's equity portfolio.

State Street's Approach

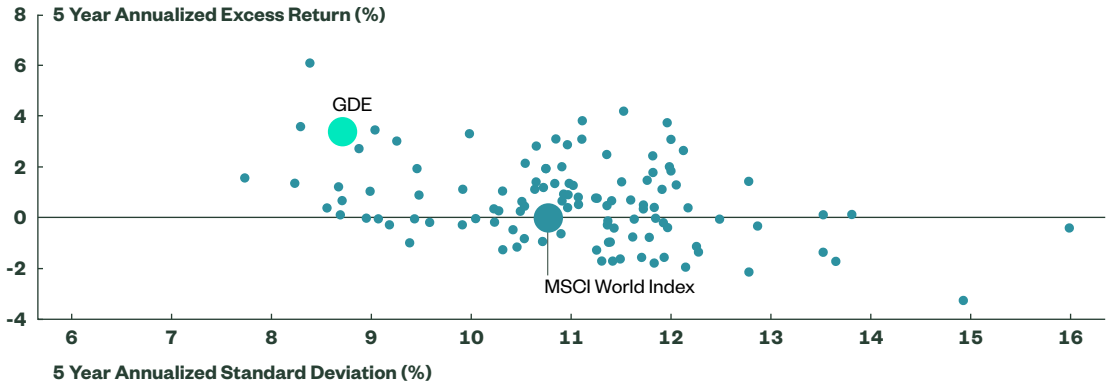
- Our global defensive equity strategy has outperformed the MSCI World Index by 1.55% annually with a 27% reduction in volatility since inception.[3]
- This rare combination of downside protection and upside capture is achieved through a benchmark unaware construction process with the dual objective of generating excess return and minimizing volatility.
- Managed by State Street's Active Quantitative Equity team, the strategy uses a proprietary model to identify stocks across a broad global investable universe based on core drivers of quality, value and sentiment.
- The strategy blends a quantitative process with human judgment as to what themes, characteristics and metrics will be predictive of future stock returns. The robust quantitative framework behind the strategy creates efficiencies, allowing for lower fees.

Working Smarter in a DC Plan

- **White label funds** Provide strong risk-adjusted returns while mitigating potential tracking error generated by a benchmark unaware approach.
- **Custom target date** Allocation near retirement can reduce volatility without adding longevity risk.
- **Stand-alone core investment option** For retirees and near-retirees.

Figure 3
Losing Less in Market Downturns Leads to Outperformance Over Time

8th Percentile	5 year return rank
76%	Upside capture
62%	Downside capture



Source: eVestment Global Large Cap Core Universe as of January 15, 2019. There are 122 strategies (including GDE) in the eVestment Global Large Cap Equity Universe that have 5 years of history and are hence included in the scatter, however the full universe includes 255 as of the date mentioned. The GDE performance shown is of a composite consisting of all discretionary accounts using this investment strategy. The above information is considered supplemental to the GIPS presentation for this Composite, which can be found in the Appendix or was previously presented. A GIPS presentation is also available upon request. Returns greater than one year are annualized. Returns represent past performance and are not a guarantee of future results. Current performance may differ from the performance shown. Returns shown are asset - weighted using Composite member market values, where the Composite member's return calculations are time-weighted and reflect the reinvestment of dividends and other income. These performance figures are provided gross of fees and expenses other than actual trading fees and expenses, and reflect all items of income, gain, and loss. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income and the reinvestment of dividends (net of withholding tax rates) and other income. performance is calculated in US dollars.

Emerging Markets Enhanced

Alpha Through Consistency

Managing risk is crucially important for retirees, but greater measures must be taken to close the funding gap that today's participants face. We believe that emerging markets are a key allocation in any participant's diversified portfolio given the potential for materially higher long-term returns relative to developed markets. Structural inefficiencies in emerging markets also present significant alpha opportunities, but alpha only meaningfully impacts participant outcomes if it is delivered consistently — an objective that the majority of pure active approaches have historically failed to deliver upon.

Enhanced strategies offer the potential to deliver consistent alpha at relatively low levels of tracking risk — reducing the likelihood of poor participant decision-making — at a lower cost than pure active approaches.

State Street's Approach

- Our emerging markets enhanced strategy targets the 'sweet spot' of returns by seeking to maximize excess return per unit of risk in a fee efficient manner.
- The strategy has delivered 98 basis points of excess annual return (in line with its 0.75%–1.00% target) over the market-cap weighted benchmark with 0.91% historical tracking error.[4]
- The five-year information ratio ranks No. 1 in the eVestment Emerging Markets Large Cap universe.[5]
- It outperformed the MSCI Emerging Markets benchmark in 103 out of 103 rolling three-year periods since inception gross of fees — enabling consistent alpha generation.[6]

Working Smarter in a DC Plan

Stand-alone core investment option is well-suited for long-saving participants seeking consistent alpha with low tracking error and fees.

Figure 4

Outperformed the MSCI Emerging Markets Index in 103 out of 103 rolling three-year periods since inception

Gross Batting Average: 100% Net Batting Average: 86%. As of December 31, 2018. Source: State Street Global Advisors, eVestment. Past performance is not a reliable indicator of future performance. Returns greater than one year are annualized. Returns represent past performance and are not a guarantee of future results. Current performance may differ from the performance shown. Returns shown are asset — weighted using Composite member market values, where the Composite member's return calculations are time-weighted and reflect the reinvestment of dividends and other income. These performance figures are provided gross of fees and expenses other than actual trading fees and expenses, and reflect all items of income, gain, and loss. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income and the reinvestment of dividends (net of withholding tax rates) and other income and are calculated in US dollars. It is not possible to invest directly in an index. Performance returns are calculated in US dollars. Calculation for value added returns may show rounding differences. The above information is considered supplemental to the GIPS presentation for this Composite, which can be found in the Appendix or was previously presented. A GIPS presentation is also available upon request.

Real Assets

Stability Through Inflation Management

The ability to spend in retirement will be impacted by more than just participants' balances on their retirement date. With inflation largely contained in recent years, people newly retired have not been adversely impacted by high or unexpected inflation.

Market history suggests that this may not be the case going forward, and as such, exposure to real assets is crucial. Actively managed real assets strategies, however, tend to come with high fees — around 80 basis points, on average[7] — and an inconsistent track record in reliably tracking inflation. The objective for this allocation should be effective inflation management — capturing the asset class efficiently and at a low cost to investors, rather than seeking excess return at the expense of higher volatility, fees and style drift.

State Street's Approach

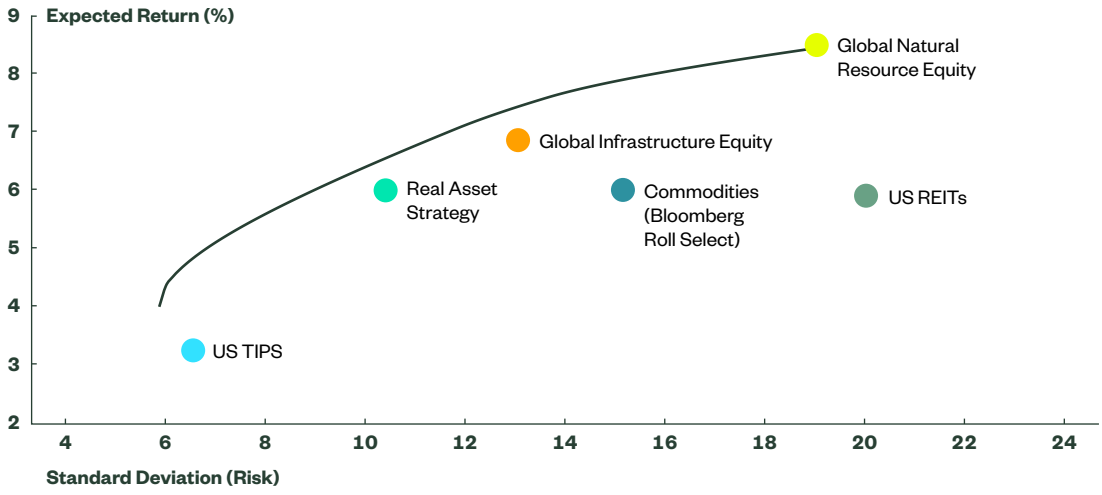
- Our real assets strategy uses a disciplined asset allocation approach that combines REITs, commodities, natural resource stocks, global infrastructure and US TIPS to provide opportunities for higher risk-adjusted returns, lower volatility, additional income and positive returns over inflation.
- Index implementation seeks to deliver accurate tracking and low turnover, at a substantially lower cost to investors than the active counterpart.
- The strategy ranked No. 1 in the eVestment Liquid Real Assets universe for net inflows in 2018.

Working Smarter in a DC Plan

Stand-alone core investment option is well-suited for long-saving participants nearing retirement and newly retired who will be most affected by inflation.

Figure 5
State Street Global Advisors Real Asset Strategy: Strategic Asset Allocation

Asset	Benchmark	(%) of Strategy
Commodities	Bloomberg Roll Select Commodity Index	25
Global Natural Resources	S&P Global LargeMidCap Commodity and Resources Index	25
Global Infrastructure	S&P Global Infrastructure Index	10
US REITs	Dow Jones US Select REIT Index	15
US TIPS	Bloomberg Barclays US TIPS Index	25



Sources: State Street Global Advisors and Morningstar. As of December 31, 2018.

Portfolio weights are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. Expected returns are based on State Street Global Advisor's Investment Solutions Group ("ISG") long-term asset class forecasted returns, long-term standard deviations and correlations as of December 31, 2018 are estimated based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved.

Investment Strategy Finesse over Fever Pitch

Age brings experience and insight. But it also introduces complexity and a degree of vulnerability, particularly in people's financial lives. With a shorter retirement savings runway, those nearing retirement more acutely feel the impact of returns — particularly in this lumbering 'lower for longer' environment — and the consequences behind each investment decision. Because the core menu is most heavily invested in by older savers, plan sponsors should be mindful of how to reinvent their core with a broader range of asset class exposures and more thoughtfully consider active management to address with more precision the needs of those nearing retirement — and in doing so, help bridge the retirement funding gap.

Endnotes

01 Employee Benefit Research Institute.

02 Assumes a starting salary of $69,460 at 55 years old with 2.5% annual growth (ending wage $88,915) and a beginning balance of $250,000. Total annual contribution rate of 11%, beta return of 5%, alpha return of 1%. 73% represents the savings from investment returns divided by total savings at 65. For illustrative purposes only.

03 Source: eVestment as of 12/31/2018.Volatility reduction is calculated by comparing annualized standard deviations of the strategy with the benchmark, which is MSCI World Index in this illustration.

04 Annual excess return is calculated as the difference between the strategy return and its respective benchmark. Tracking error is the annualized standard deviation of those excess returns.

05 As of December 31, 2018. Information ratio is calculated as excess return over the MSCI Emerging Markets benchmark per unit of tracking error. Strategy information ratio is 1.52.

06 Reflects gross of fee returns for the strategy. Reflecting the highest tier of fee for the strategy (45 basis points), the strategy has outperformed in 86 of 100 rolling three-year periods since inception.

07 eVestment. Median fee for a $10 million mandate among managers in the Real Assets universe that publish fee schedules.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third largest asset manager with US $2.5 trillion* under our care.

*AUM reflects approximately $32.4 billion (as of December 31, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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ID15899-2467647.1.1.AM.RTL 0319
Exp. Date: 3/31/2020