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CORRESPONDENCE MEMORANDUM

DATE: August 2, 2004

TO: Wisconsin Deferred Compensation Board Investment Committee

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Lifecycle/Lifestyle Funds

At the May 2004 meeting, the Wisconsin Deferred Compensation (WDC) Board discussed lifecycle and lifestyle funds as a potential option to add under the WDC's core investment spectrum. Further review of the pros and cons of adding this type of fund series to the WDC core investment spectrum was referred to the Investment Committee for further study.

As used by mutual fund firms, the terms "lifestyle" and "lifecycle" describe the process of developing a diversified investment portfolio by strategically combining different asset classes in varying proportions according to an individual participant's risk tolerance (also called risk-basis or lifestyle) or age (also called time horizon or lifecycle). These funds are designed to meet the needs of investors within a certain range of ages or time horizon and appeal most often to participants who do not have the time, knowledge or interest to regularly monitor and adjust their investment portfolio allocations. These participants struggle to make the right investment choice, worry about the choices they make, and often forget to rethink and rebalance their investments on a periodic basis.

Lifecycle and lifestyle funds are increasingly popular:

- Data analyzed by the *Wall Street Journal*[1] indicated that in recent years, target date lifecycle funds have grown faster than lifestyle funds.
- A May 2004 PlanSponsor.com survey revealed that nearly 77% of survey respondents offered either a lifecycle or lifestyle fund.
- Many s. 457 providers are either evaluating (South Carolina, New Mexico, and New York City) or already offer a version of lifecycle or lifestyle funds. The Nevada s. 457 plan reports that approximately 5.5% of their assets are invested in these funds, which equates to about $14.4 million.
- Fidelity Freedom Funds are part of s. 457 plans offered by Kentucky, Colorado PERA and Sacramento County, California.
- T. Rowe Price reports over 70,000 participants with slightly over $1.062 million in T. Rowe Price's target-based or lifecycle funds, and 110,000 participants with assets of $1.265 million in T. Rowe Price's risk based fund series.

[1] "Lifecycle Funds Tend to Be Great Core Holding" Jonathan Clements. *Wall Street Journal* February 24, 2004.

Reviewed and approved by Pam Henning, Office of Strategic Services

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Signature Date

Benefits for WDC participants:

- Easier for new participants to understand. They are a single solution with minimal involvement. This reduces participant responsibility and anxiety over the complexity of making and monitoring investment decisions.
- No particular investment expertise or skill needed. Guesswork and confusion minimized as the number of choices is reduced.
- Provides a thorough mix of assets, automatic rebalancing and reallocation.

Benefits for the WDC Program:

- Appears to be the easiest options for participants to understand and enroll in.
- Addresses concerns regarding offering investment advice.
- Uses modern portfolio theory (risk/return etc.).
- Mutual fund family develops and maintains asset mix in fund, not WDC or participant.
- Mutual fund family keeps fund on target with systematic rebalancing.
- Appeals to participants with low investment knowledge or compensation levels.

Prior to any decision on adding a lifecycle or lifestyle fund series to the Investment Spectrum, the Board asked staff to review the existing asset allocation service and examine how adding a lifecycle or lifestyle fund would fit with it and the objectives of the WDC.

<u>WDC Asset Allocation Service</u>
The WDC currently offers a form of lifestyle funds with the WDC's customized asset allocation service, which was added in 1998. The WDC asset allocation service allows participants to potentially maximize return and realize investment objectives while reducing total investment risk to the participant's investment portfolio through diversification.

Based on the number of participants that indicated a need for a simple approach to investments, staff anticipated that the WDC asset allocation service would be extremely popular. Original estimates for use ranged from 20% to 40% of WDC participants. As of June 30, 2004, just over 20% of WDC participants are utilizing the service. The table below provides data on WDC participant use of the asset allocation service since inception:

WDC Asset Allocation Service

Year	# Starting Asset Allocation	Total # w/ Asset Allocation	WDC Population	WDC Population w/ Asset Allocation
1998	1,319	1,319	31,603	4.2%
1999	1,858	3,098	33,395	9.3%
2000	2,224	5,141	35,827	14.3%
2001	1,610	6,490	37,809	17.2%
2002	1,509	7,606	39,164	19.4%
2003	956	8,054	40,593	19.8%
2004	555*	8,446*	41,595*	20.3%*

* as of 6/30/04

Overall, it appears that the WDC participant population base has not embraced use of the asset allocation service as quickly as initially anticipated.

The table below provides a breakdown of WDC asset allocation service use by age, as of December 31, 2003. As the table shows, the greatest use of the asset allocation service is by younger participants. As of December 31, 2003, approximately 41% of participants age 26 to 35 and 26% of participants age 36 to 45 were enrolled in the asset allocation service. It seems that younger WDC participants are getting the message that asset allocation is a good idea and acting on that information to enroll.

WDC Asset Allocation Service by Age (as of 12/31/03)

AGE	# using Service	Total in Age Bracket	% of Age Bracket Using Service
25 and under	868	1,446	60.0
26-35	2,857	6,918	41.3
36-45	2,756	10,745	25.6
46-55	2,340	13,870	16.9
56-65	613	5,965	10.3
66 and older	42	1,424	2.9

Based on information from the WDC staff, however, participants have some problems using the asset allocation service effectively, including difficulty in developing their personal asset allocation model. Some participants begin using the service and forget; they don't remember they elected and call regularly to find out why a change occurred in their accounts. Difficulties experienced with the WDC's asset allocation mirror examples found in a recent literature search, which also include the problem of participants failing to adjust their allocations as they age or change their risk tolerance. Other problems include situations where participants understand the need to maintain a diversified portfolio and how the asset allocation service can accomplish this, but they still are uncertain which investment options to use.

Asset Allocation Service Changes

Year	Asset allocation participant total	Asset allocation participants making changes
1999	3,098	200 (6.4%)
2000	5,141	508 (9.9%)
2001	6,490	598 (9.2%)
2002	7,606	737 (9.7%)
2003	8,054	759 (9.4%)
2004*	8,446*	1,238 (14.6%)

* as of June 30, 2004

WDC Objectives

The stated objective of the WDC is to be a supplemental retirement savings program for public employees that provides participants with the ability to invest pre-tax income in a broad range of investment alternatives.

WDC participants are a diverse group. The 2002 Cortex survey revealed that WDC participants can be categorized into three groups based on their knowledge of investment concepts: a group of high knowledge, high interest participants (24%); a group of average participants (53%), both in knowledge and in interest; and a group of participants (23%) that indicated that they had either slightly poor or extremely poor investment knowledge. This last group is just as interested as the other groups in making deferrals but lacks the investment knowledge regarding where to put their funds.

Regardless of their investment knowledge, WDC participants rely on the Board to provide them with solid investment options. While the WDC has done a good job of meeting the needs of the high knowledge, high interest group through the addition of the Schwab Personal Choice Retirement Account option, and the core options provide many good investment alternatives for the average WDC participant, there does not seem to be a similar level of service for lower knowledge and interest participants. These participants would likely benefit from the inclusion of a lifecycle fund series in the WDC or a renewed education and marketing effort on the existing asset allocation service.

<u>Options</u>
Based on the information presented here, the Investment Committee could make one of four recommendations to the Board regarding the asset allocation service and lifecycle or lifestyle funds.

1) Do nothing. Keep the existing asset allocation service as is. If this option is recommended, staff recommend that the Board ask the WDC staff to focus on education and reminders to participants about the value of enrolling and keeping allocations up to date with risk tolerance.

2) Add a lifecycle (time horizon) fund series for use in conjunction with the existing asset allocation service. This could meet the needs of a large portion of WDC participants. This might be complicated and require an education campaign but might also serve the greatest number of low-investment knowledge participants. Passive participants could select a lifecycle fund, while those with a little interest or knowledge could opt to enroll in the asset allocation service.

3) Phase out the existing asset allocation service and add a lifecycle fund series. Although it would likely require an education campaign, this option would be slightly less complicated than option 2 and would still serve a great portion of less-knowledgeable or interested participants.

4) Phase out the existing asset allocation service and add a lifestyle (risk-basis) fund series. Staff does not recommend replacing the existing asset allocation service with a lifestyle fund series. The service is working as intended, and changing to a lifestyle fund would create confusion for participants without providing any great benefit.

<u>Recommendation</u>
Staff recommend Option #2: adding a lifecycle (time horizon) fund series to the WDC Investment Spectrum in conjunction with the existing asset allocation service. Adding a lifecycle option could provide a benefit to certain segments of the WDC participant population not currently being served under the WDC Program. Lifecycle funds require the least engagement and fewest decisions by participants, and less investment education is required than is needed for lifestyle funds. In addition, early results from the 2004 participant survey show that a majority of respondents said they would be very or somewhat interested in these funds.

Department staff believes there is merit in retaining the existing asset allocation service. This service is risk-based; participants analyze their risk tolerance, then allocate their WDC assets based on that knowledge. However, if this service is to continue, staff should also work with NRS to develop and distribute additional educational materials that help increase participants' knowledge and understanding of the WDC's asset allocation service.

<u>Next Steps</u>

If the Investment Committee agrees with this recommendation, it will be presented to the Board at the November 9, 2004, meeting. If the Board approves the recommendation, staff will work with NRS to review lifecycle fund options for presentation to the Investment Committee and Board in 2005.

As noted in a previous memo to the Board on this topic, if lifecycle funds are added, the Board would also need to amend the WDC Investment Policy statement to add lifecycle funds as an investment category within the core spectrum. In addition, investment option selection and monitoring criteria will need to be revised to provide for a waiver or for the development of a customized benchmark such as a benchmark established by the proportional allocations of the benchmarks of the underlying asset classes, if possible.