Restructuring a Multi-Manager Plan: A Case Study

As defined contribution (DC) plans grow in size, more and more of them are taking advantage of institutional multi-manager structures in their fund lineups. According to Callan’s 2018 DC Trends Survey, 25% of DC plans have at least one multi-manager or white label option, up from 17% in 2016.

White label funds, which use a mix of underlying funds to provide a simple but rich exposure to an asset class, can simplify the investment lineup, solve capacity problems with current fund options, help participants understand the role of a fund through intuitive labeling, and allow plan administrators to more easily swap out underperforming funds. However, like any investment option in a DC plan, they must be well thought-out and frequently revisited.

In this quarter’s DC Observer, we describe the restructuring of one city-sponsored 457(b) plan with nearly $1 billion in assets that uses multi-manager funds. The revamping process examined the investment fund structure, participant enrollment, and investment management fees. The specific goals of the project included upgrading the plan’s existing white label options to reduce costs and complexity, and moving to appropriate target date funds to replace a risk-based fund suite.

The exercise provided important lessons in multi-manager fund structures, and ultimately resulted in a greatly improved DC plan.

**The Results**

After this process, the plan saw:

- An increase in participation of 20 percentage points
- A decrease in investment management fees across the board
- A simplification of the fund structure and elimination of little-used options in the former plan

**The Previous Plan Structure**

The city’s 457(b) plan had just over $850 million in assets, and it is not subject to ERISA. When the city hired Callan as its investment consultant, its plan’s investment menu contained a mix of multi-manager and single manager funds, and the plan did not have an automatic enrollment feature.

The participant population included two primary groups: public safety employees and all other city employees. All employees also have access to a well-funded and generous defined benefit (DB) plan. The savings and participation rates, especially among...
women, minorities, and low-wage workers, were lower than the city found desirable, and it wanted a structure that improved those levels.

Before the restructuring overseen by Callan, the plan included the following elements (Exhibit 1):

- Four asset-allocation options in target risk funds labeled “conservative,” “accumulator,” “wealth builder,” and “aggressive”
- Two core passive options: U.S. equity and non-U.S. equity
- Three core active options: a stable value fund for capital preservation; a multi-manager fixed income fund; and a multi-manager global equity fund
- Two specialty options: a socially responsible investing (SRI) fund and a brokerage window

The use of the asset allocation funds was very low at under 3% of assets (compared to the typical plan’s 31% allocation to target date funds). Also at issue were the names of the “do-it-for-me” Tier I options, which did not necessarily make clear their investment objectives.

Callan identified several issues with the active multi-manager funds: The global equity fund was heavily allocated to smaller cap stocks, akin to a global mid cap core/growth fund, with an 80/20 U.S./non-U.S. split that did not reflect market cap globally (45/55). Meanwhile, the fixed income option took on significantly more risk than the Bloomberg Barclays U.S. Aggregate Bond Index, even though it was the only fixed income option in the DC plan other than the stable value fund.

Our evaluation also found that use of the SRI fund was extremely low, at approximately 1% of plan assets, and the fund was closely correlated to, and had holdings that significantly overlapped with, the S&P 500.

Finally, Callan found opportunities to reduce plan fees.

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**Exhibit 1: The Existing Plan Lineup**

<table>
<thead>
<tr>
<th>Risk Spectrum</th>
<th>Tier I Asset Allocation Options</th>
<th>Tier II Core Passive</th>
<th>Tier II Core Active</th>
<th>Tier III Specialty Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>Target Risk Funds</td>
<td>Capital Preservation</td>
<td>Fixed Income</td>
<td>Socially Responsible</td>
</tr>
<tr>
<td></td>
<td>Conservative</td>
<td>Stable Value</td>
<td>Actively Managed</td>
<td>Balanced Socially</td>
</tr>
<tr>
<td></td>
<td>Accumulator</td>
<td></td>
<td></td>
<td>Conscious</td>
</tr>
<tr>
<td></td>
<td>Wealth builder</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Aggressive</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Passive U.S. Equity</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Total Stock Market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Passive Non-U.S. Equity</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>FTSE All World ex-US</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Global Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Actively Managed Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Brokerage Window</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ACME Brokerage Window Co.</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Callan

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1 Callan DC Index™
Restructuring the Plan’s Investment Menu

As a first step, the plan directed an existing sub-committee of its investment committee to handle issues related to the restructuring, since the city realized that this would be a long-term process (three years in total) and it wanted to make sure it had the appropriate level of resources committed to the project.

The next critical step involved changing the custodian, a decision that Callan advised since all of the subsequent changes relied on having a top-tier trust custodian in place. The board agreed to this course of action.

After that the plan and Callan started a comprehensive investment structure evaluation process and designed a new structure based on the outcome. We searched for managers to fill the slots that were part of the new investment structure.

The plan next faced a judgment call: Whether to implement the fund changes while searching for a recordkeeper, or delay the changes until the new recordkeeper was in place. The plan decided to do the latter.

At the most fundamental level, Callan advises plans to use a three-tier structure (Exhibit 2), and so we recommended and the plan agreed to use that essential framework. In such a structure:

- Tier I offers choices for participants who want a “do it for me” option
- Tier II is for participants who want more control within certain guidelines
- Tier III is for “do it myself” investors

As previously noted the Tier I choices were confusing to participants and suffered from low usage. We recommended that the plan switch to target date funds (TDFs), as behavioral research finds that participants are better equipped to identify a fund that is appropriate for their time horizon versus their risk tolerance. The TDFs were chosen via a suitability study that took

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Exhibit 2: Callan’s Recommendation for the New Lineup

<table>
<thead>
<tr>
<th>Risk Spectrum</th>
<th>Tier I Asset Allocation Options</th>
<th>Tier II Core Passive</th>
<th>Tier II Core Active</th>
<th>Tier III Specialty Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>Target Date Funds 5-Year Increments</td>
<td>Capital Preservation Stable Value Fund</td>
<td>Global Fixed Core Plus Fixed Income Fund</td>
<td>Brokerage Window ACME Brokerage Window Co.</td>
</tr>
<tr>
<td>Aggressive</td>
<td>U.S. Equity Passive Manager</td>
<td>Global Equity Multi-Manager Equity Fund</td>
<td>Non-U.S. Equity Passive Manager</td>
<td></td>
</tr>
</tbody>
</table>

Source: Callan
into account the various retirement ages of the two primary populations—public safety employees and everyone else. The glide path was selected because it offered the optimal combined outcomes for the two populations, who retire on average at ages 53 and 60, respectively.

We then evaluated the rest of the tiered lineup and found it generally sound. Much of Callan’s work then centered on restructuring the existing multi-manager options.

The original multi-manager fixed income option was not structured to be a “low risk anchor” for participants. Compared to the Bloomberg Barclays Aggregate (Exhibit 3), the option had a much lower quality distribution, and it had a large number of underlying managers with many different sector exposures. It also included a number of 1% and 2% allocations being handled by various managers, which could be consolidated for fee savings.

Exhibit 3: How the Original Fixed Income Option Compared to the Index

![Exhibit 3: How the Original Fixed Income Option Compared to the Index](image-url)

Source: Callan
In our view, the fixed income option should be an effective diversifier and offer downside protection in the event of a bear equity market. As such, Callan recommended a more conservative, well-diversified, and simple structure (Exhibit 4) using three active fixed income managers (Callan generally favors active management in fixed income). Based on those recommendations, the plan decided to use a core plus fixed income vehicle comprising 70% in core fixed income (benchmarked to the Bloomberg Barclays Aggregate Index), 15% in unhedged global bonds (benchmarked to the Bloomberg Barclays Global Aggregate Bond Index), and 15% in opportunistic fixed income (benchmarked to LIBOR + 300 basis points).

A 70% core / 30% satellite structure limits credit risk and provides better downside protection in a bear equity market:
- Core bond allocation anchors the portfolio
- Non-U.S./global fixed income expands the opportunity set and offers a differentiated source of return
- The opportunistic manager can tactically allocate to non-benchmark sectors; e.g., high yield, non-U.S. fixed, or emerging market debt
- Lower risk could be achieved by allocating to shorter-duration bonds, but this would lower returns over the long run. Also, the capital preservation option could be used by participants to lower duration.

To implement the redesigned core plus bond fund, Callan initially proposed two core bond managers, but the plan ended up only hiring one given the size of the allocation. Callan next did searches for an active global bond manager and an active absolute return fixed income manager. This new structure has comparable risk and a slightly higher projected return than the Bloomberg Barclays Aggregate, with a 0.08 correlation to the S&P 500 at the time it was launched. It charges an investment management fee of 35 bps, which is lower than the previous fixed income option.

Next we examined the original multi-manager global equity fund, which exhibited some strong biases to U.S. equities, growth stocks, and small cap stocks.

Our starting point (given a clean sheet of paper): The global equity structure should be neutral to the global market in regard to style, capitalization, and emerging market exposure, unless the investor has a compelling preference to tilt the structure. Active and passive management can be complementary in different market situations. However, the case for active management varies greatly by market capitalization:
- Passive is typically appropriate for large cap U.S. equity
- Active management is compelling for small/mid cap, global ex-U.S. equity, and non-U.S. small cap

Exhibit 4: The New Fixed Income Structure

<table>
<thead>
<tr>
<th>Manager</th>
<th>Benchmark</th>
<th>Recommended Allocation %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core/Core Plus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core Bond Manager</td>
<td>Bloomberg Barclays Agg</td>
<td>70%</td>
</tr>
<tr>
<td>Global/Non-U.S. Fixed Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Manager</td>
<td>Bloomberg Barclays Global Agg</td>
<td>15%</td>
</tr>
<tr>
<td>Opportunistic Fixed Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Manager</td>
<td>LIBOR + 300 bps</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: Callan
We recommended a style- and capitalization-neutral structure with more non-U.S. equity exposure than the old structure to diversify the portfolio and expand the opportunity set (Exhibit 5). The structure is simpler (six managers) and would cut fees in half by passively managing large cap U.S. equity. We recommended that the structure keep a U.S. equity home bias (with a 40% allocation to non-U.S. equity). Participant spending needs (i.e., plan liabilities) are denominated in U.S. dollars and this structure has less currency risk than a market-neutral global equity structure. The U.S. equity portion is style- and capitalization-neutral compared to the Russell 3000.

The structure is just over 50% actively managed; we recommended large cap U.S. equity be 100% passively managed to reduce fees. Overall investment management fees for this structure were reduced to 41 bps after the restructuring.

Regarding Tier III of the plan structure, Callan recommended and the city agreed to keep the brokerage window but eliminate the SRI option, which was not widely used. Part of the rationale was that participants who wanted an SRI option could access one through the brokerage window.

Re-engaging Participants

As part of the restructuring, the plan conducted a reenrollment, which exempted certain groups due to collective bargaining as well as retirees, since it was determined that most retirees invested mostly or wholly in the stable value fund. Reenrollment included defaulting to a savings rate of 5%, adding an optional auto-escalation feature, and mapping all assets to the age-appropriate TDF unless otherwise directed by plan participants.

The reenrollment included direct, outbound calls by the newly selected recordkeeper and plan staff. Reenrollment continues to occur annually for non-participating employees (although assets are not reenrolled annually into the TDFs).

As a result of these steps:

- The savings rate increased from 4.7% to 5.7%.

Exhibit 5: The New Equity Structure

<table>
<thead>
<tr>
<th>Manager</th>
<th>Benchmark</th>
<th>Recommended Allocation %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Large Cap Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Passive Large Cap Core</td>
<td>Russell 1000/S&amp;P 500</td>
<td>48%</td>
</tr>
<tr>
<td><strong>Small/Mid Cap Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Manager A</td>
<td>Russell 2500 Value</td>
<td>6%</td>
</tr>
<tr>
<td>Active Manager B</td>
<td>Russell 2500 Growth</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Global ex-U.S. Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Manager C</td>
<td>MSCI ACWI ex USA</td>
<td>17.5%</td>
</tr>
<tr>
<td>Active Manager D</td>
<td>MSCI ACWI ex USA</td>
<td>17.5%</td>
</tr>
<tr>
<td><strong>Non-U.S. Small Cap</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Manager E</td>
<td>MSCI ACWI ex USA Small</td>
<td>5%</td>
</tr>
</tbody>
</table>

Large Cap Equity 48%
Small/Mid Cap Equity 12%
ACWI ex USA 35%
Non-U.S. Small Cap 5%

Source: Callan
The participation rate initially improved from 63% to 83%; one year later it stood at 91%. The biggest improvements were seen among women, minorities, and low-wage employees.

- Asset allocation improved dramatically, with do-it-for-me fund assets jumping to 24% of plan assets.
- Due to outreach efforts, a majority of participants made active elections during the reenrollment process, even if the active election was to choose to remain in the default TDF after having that option explained to them.
- During the reenrollment, Callan worked closely with the recordkeeper and stable value fund manager to provide data to ensure that the appropriate cash buffer was in place.
- The plan also added a managed account solution, offering additional asset allocation assistance and advice for plan participants who do not opt into the discretionary service.

The Bottom Line
In addition to the successes for increased participation, this new structure significantly improved the plan’s fee structure:
- Fees for the active equity fund declined by 46 basis points to 41 bps
- Fees for the active fixed income fund declined by 23 bps to 35 bps
- Fees for all index funds declined due to a move to collective investment trusts
- Recordkeeping costs were reduced, while the quality of service has increased

Conclusion
Even the best-designed plans could benefit from a thoughtful evaluation of their current structure, especially since participant demographics, fund choices, and investment fee practices will likely have changed since the last examination of the plan.

To achieve the best outcomes, plan sponsors should:
1. Start the process with clear goals in mind
2. Be prepared to reevaluate all aspects of the plan from the recordkeeper to fund selection to participant communication
3. Identify the committee or individuals who will participate in the process and ensure they have the necessary time
4. Understand the process may be lengthy, and have a realistic timeline
5. Be prepared to make critical, interwoven decisions as the process unfolds
6. Strongly consider making all changes at once rather than handling the changes in stages
7. Measure outcomes

As the city discovered, with the right amount of preparation and a clear-eyed vision of the ultimate objectives, sponsors working with a consultant can discover that their plan can be materially improved, with reduced fees, better investment choices, and higher rates of participation by those in the plan.
Authors

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Ben has earned a BA from Reed College, a Masters of International Political Economy and Development from Fordham University, and a Masters of Public Policy from Harvard University’s Kennedy School of Government.

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Mike joined Callan in 2000 as a member of Callan’s Institutional Consulting Group, and was responsible for supporting investment manager clients in the East, Southeast, and Midwest.

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The *DC Observer* is a quarterly newsletter that offers Callan’s observations and opinions on a variety of topics pertaining to the defined contribution industry. For defined contribution inquiries, please contact Jimmy Veneruso at 312.346.3536.

*Editor – Stephen R. Trousdale*

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<th>Corporate Headquarters</th>
<th>Regional Offices</th>
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<td>Atlanta</td>
</tr>
<tr>
<td>Atlanta</td>
<td>Denver</td>
</tr>
<tr>
<td>Suite 800</td>
<td>800.522.9782</td>
</tr>
<tr>
<td>San Francisco, CA 94111</td>
<td>Chicago</td>
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<td>800.227.3288</td>
<td>800.999.3536</td>
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<td>415.974.5060</td>
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