CFDD Conference

Transformation of Active Management in DC Plans

October 2014

Moderator

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F-Squared Investments

F-SQUARED INVESTMENTS

Panelists

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Agenda

- Background
- Legal perspective
- Plan sponsor in practice
- As part of a 3(38) offering
- Discussion

TRANSFORMATION OF ACTIVE MANAGEMENT

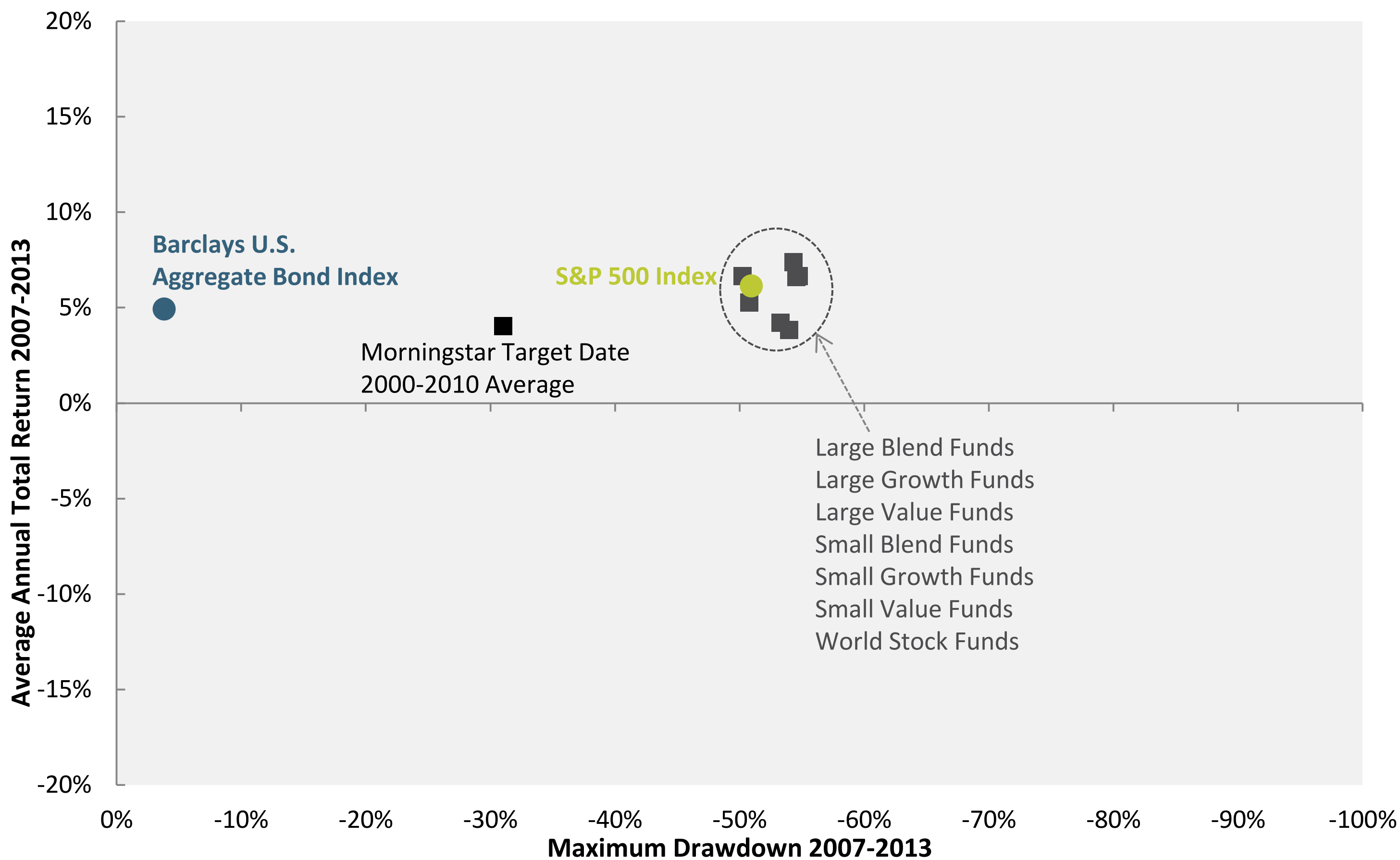
Traditional investment philosophies

- Active management – Outperform a benchmark
- Passive management – Deliver the benchmark at low cost

New active philosophies

- Not tied to benchmarks
- Outcomes-focused "solutions"
- Meeting specific client needs

TRADITIONAL ACTIVE – DIFFICULTY IN ADDING VALUE



Past performance is not indicative of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expense and is not based on actual advisory client assets. Index performance does include the reinvestment of dividends and other distributions.
Source: Morningstar Direct data, F-Squared analysis.

WHY THE SHIFT TO OUTCOME-ORIENTED INVESTING?

New Investor Expectations

	Allocation-Oriented Approach	Outcome-Oriented Approach
Investor Objective	• Beat return bogey	• Improve probability of meeting future cash-flow needs
Investor Framework	• Static allocation • Historical return assumptions across asset-classes • Capital-weighted • Primary Investor effort: manager selection	• Dynamic allocation • Prospective return assumptions across risk factors • Risk-weighted • Primary investor effort: risk allocation
Manager Implications	• Narrow mandates tied to benchmark • Differentiation on product and process features	• Broad mandates: only risk factor is well-defined • Differentiation on application: how does this strategy fit with client-specific objectives?

Source: Casey Quirk.

ACTIVE MANAGEMENT - CURRENT AND FUTURE FLOWS

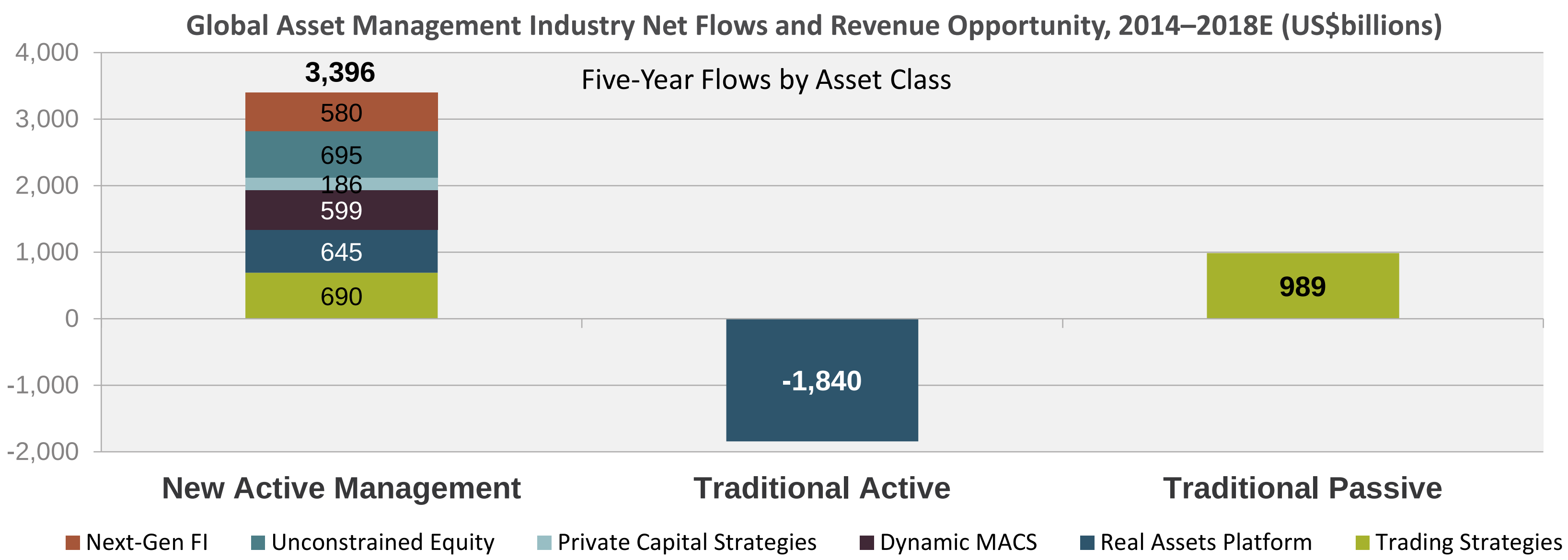
Net inflows of 1.3T were highly concentrated in three areas from 2008 – mid-2012[1]

- Passive products, "Solutions," (including TDFs) & Alternatives

$400B flowed out of relative-return equity funds ($1.3T) during the same timeframe[1]

"New Active" investment strategies will attract $3.4T of asset flows by 2018[2]

- Passive strategies will attract ~$1T
- Traditional active strategies will lose ~$1.8T



1 Casey Quirk – Life After Benchmarks 2013.
2 Mckinsey & Company – Solutions are the New Alpha 2014.

IMPORTANT INFORMATION

Past performance of an index is not a guarantee of future results.

References to Non-AlphaSector Indexes

Standard & Poor's 500 Index (Total Return) ("S&P 500") is a broad-based unmanaged index of 500 stocks, which is widely recognized as a representative of the equity market in general.
The Barclays U.S. Aggregate Bond Index (Total Return) ("Barclays Aggregate Bond") is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS.

F-Squared Investment Management, LLC or one of its subsidiaries is the source and the owner of all AlphaSector Indexes and their performance information.

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This information is general in nature and should not be considered tax advice. Investors should consult with a qualified tax consultant as to their particular situation.

F-Squared Investments is an asset manager who provides investment indexes and strategies based on its AlphaSector® and Portfolio Replication Technology capabilities. The firm delivers investment solutions to help meet investor's expectations and serves clients in the advisor, institutional, retail and retirement markets. As of June 30, 2014, F-Squared affiliated entities had over $25 Billion in fee-generating assets.

www.f-squaredinvestments.com
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New Active Investment Solutions

Marcia S. Wagner, Esq.

The Wagner Law Group
A Professional Corporation

Fiduciary Considerations for Adding New Options

- ERISA Fiduciary Standards
  - Require adaptation to changing circumstances.
  - Must take participant needs into account.
  - Should take participant risk tolerance and desired outcomes into account.
  - Investment options not available in the past may be prudent and desirable today.

Offering New Active Solutions in Plans

- New Active Solutions for DC Plans
  - Focusing on risk and retirement outcomes
  - May be in the form of target-date or risk-based strategies
- Comparison to Traditional DC Solutions
  - Tactical Asset Allocation
  - Alternative Investments

New Active Solutions with TAA

- Plan Sponsors' Growing Interest in Outcomes
  - Asset managers respond with Tactical Asset Allocation (TAA)
  - Utilizing TAA to provide downside risk management
- Complexity and Diversity of TAA Strategies
  - Systematic vs. Discretionary Tactics
  - Frequency of Tactical Changes
  - Constrained vs. Unconstrained

Fiduciary Standards for New Active Solutions

- ERISA Section 404(a) Standards
- Fiduciary Duty of Prudence
  - Must give "appropriate consideration" to all relevant facts.
  - Tactical strategy should be grounded in Modern Portfolio Theory and generally accepted.
- Fiduciary Duty of Diversification
  - Must minimize risk of large losses.
  - Tactical strategy should not increase risk beyond acceptable range.

Fiduciary Process for Adding New Options

1	2	3	4	5
Evaluate the products available	*Assess how products meet participant needs*	*Understand the investment process of chosen products*	*Assess the reasonableness of fees*	*Review the Investment Policy Statement and modify, if needed*

Potential Benefits and Fiduciary Advantages

- Purpose of New Active Solutions with TAA
  - Provide market-based returns and downside protection.
  - May include multi or single asset class portfolios.
- Benefits for Plan Fiduciaries
  - Focusing on outcomes and diversification can help plan sponsors meet fiduciary duties.
  - Returns are not benchmark-driven, lowering correlation with traditional strategy returns.
  - Potential risk if plan fiduciaries do not consider possibility of new active solutions?

Evaluating New Active Solutions with TAA

- Importance of Following Prudent Process
  - Utilization of risk management does not guarantee risk will actually be mitigated.
  - Defensive action may come too late or taken prematurely.
  - Returns are not linked to traditional benchmark index.
  - Other measurements needed to evaluate solution's risk management feature and performance.

Best Practices for Evaluating Performance

- Comparison to Similar New Active Solutions
  - Simply identify competing strategies and their performance.
- Utilizing Customized Benchmarks
  - Use composite of conventional benchmark indices, weighted by strategic allocations.
- Risk-Adjusted Performance Metrics
  - Provides measure of investment returns relative to portfolio's level of risk (e.g., Sharpe Ratio).
  - Facilitates comparison of new active solution against traditional investment strategies.

IPS Guidelines for Tactical Asset Allocation

- IPS-Related Challenges
  - May contain rigid provisions discouraging or prohibiting new active solutions.
  - May require all investment options to be evaluated based on conventional benchmark indices.
  - May fail to provide helpful criteria for evaluating benchmark-agnostic strategies.
  - Plan fiduciaries may not have sufficient guidance for evaluating strategies with active risk management.

Revising IPS for New Active Solutions

- Modification of IPS Guidelines
  - Amend guidelines to expressly permit new active solutions with outcome-oriented strategies.
  - Add supplemental investment criteria to aid in evaluation of new active solutions.
- Recommended Procedural Guidance for IPS
  - Compare performance against similar strategies.
  - Use customized benchmarks.
  - Evaluate risk-adjusted metrics.
  - Amend IPS to permit, but not require, use of alternative measures.

DC Plans and Alternative Investments

- Increasing Interest in Alternative Investments
  - 92% of DB plans in private equity, and 60% of DB plans in hedge funds (GAO Survey 2010).
  - Perception that alternative investments decrease overall portfolio volatility.
  - Growing interest among DC plan stakeholders.
- Gaining Exposure to Alternative Investments
  - Less interest and securities law issues for alternative investments offered as standalone options in plans.
  - Exposure may be gained through pooled investment vehicles (such as mutual funds and CIFs).

Special Fiduciary Considerations for Alternative Investments

- Tradeoff for Plan Investors
  - Give up liquidity and transparency.
  - Gain potential stability of returns and diversification.
- Key Areas of Fiduciary Review
  - Expertise of pooled vehicle's adviser in alternative investments.
  - Fee structure for alternative investments (which may include multiple layers of fees and performance fees).
  - Illiquidity of alternative investments and liquidity needs of pooled vehicle and plan.

Conclusions

- Constant Evolution of Investment Products
  - Emerging trend and growing interest in improving participant outcomes and managing risk.
- New Investment Solutions
  - Tactical asset allocation and alternative investments may require special fiduciary considerations.
  - May also require changes to IPS document.
  - Can help both participants and plan fiduciaries mitigate substantial risk.

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Hybrid of a Pension & 401(k)…….

Defined Benefit (DB)

"Pension Plans"

Defined Contribution (DC)

"401(k) Plans"

SAVINGS & RETIREMENT PLAN

H-E-B Brand

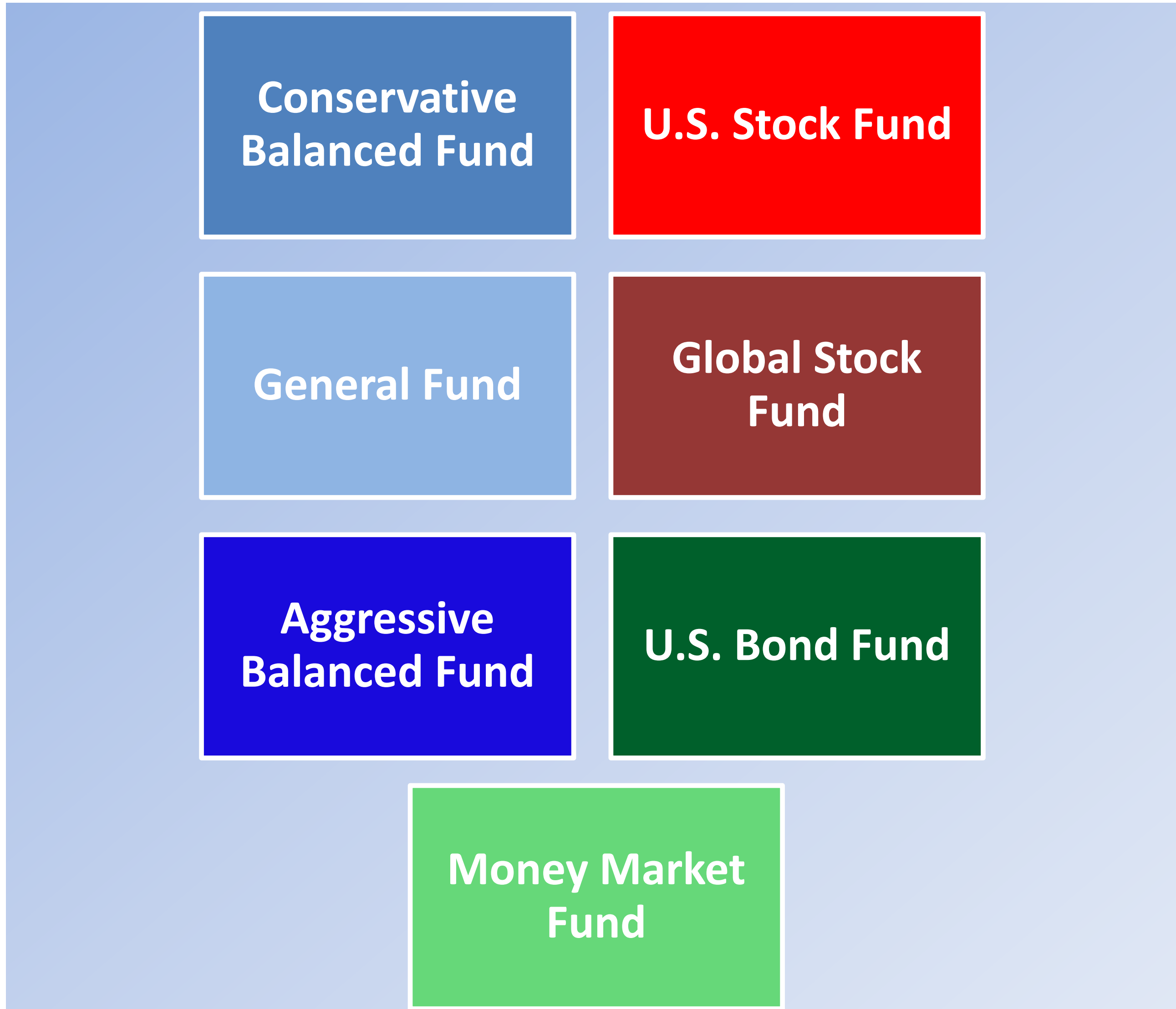
What Fund’s make up the Plan?

- 7 Participant Options

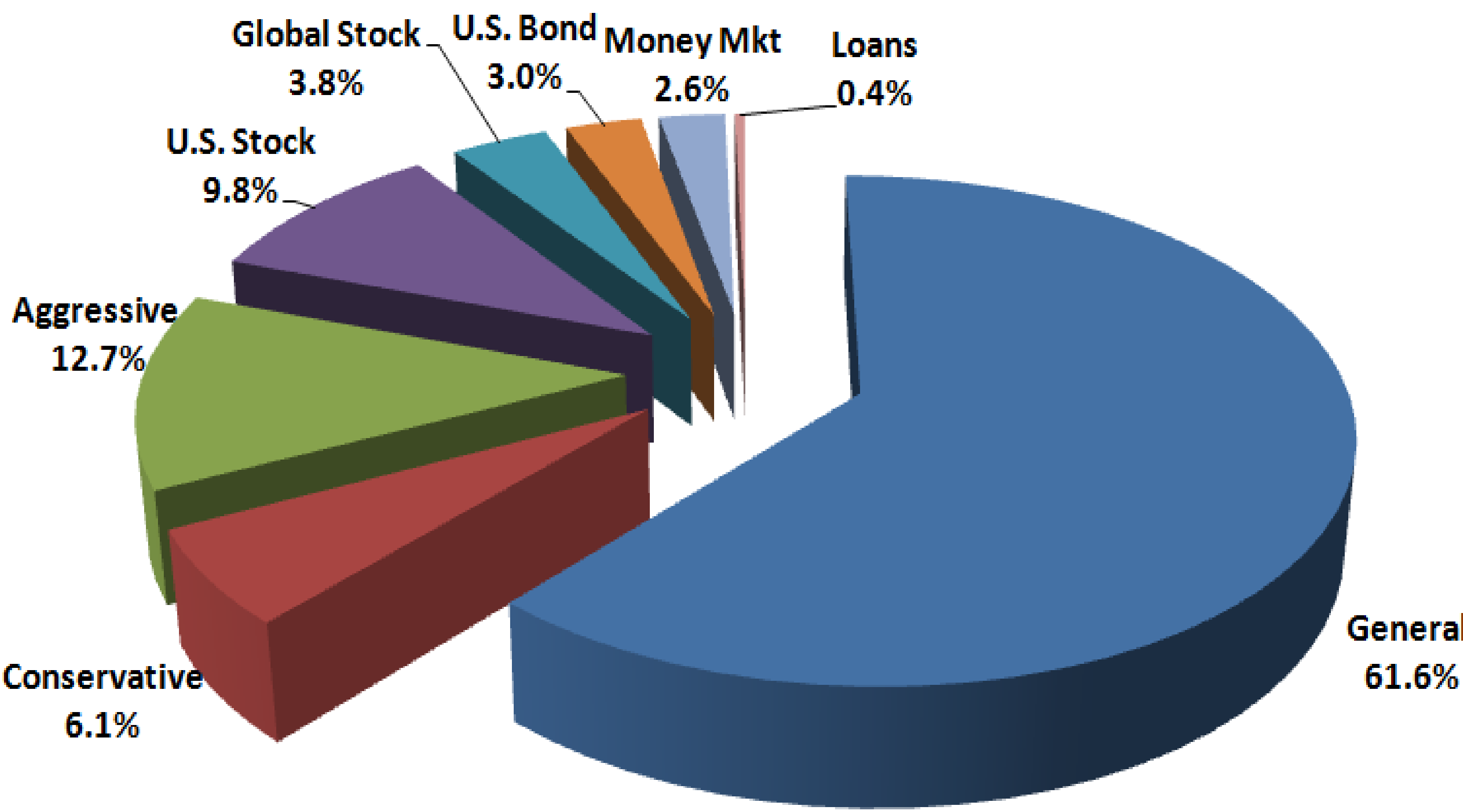
- 3 “Target Risk” Funds: Enhanced Balanced Portfolio (Conservative, General, Aggressive). Active only.

- 4 “Index” Funds (U.S. Stock, Global Stock, U.S. Bond, Money Market). Passive only.

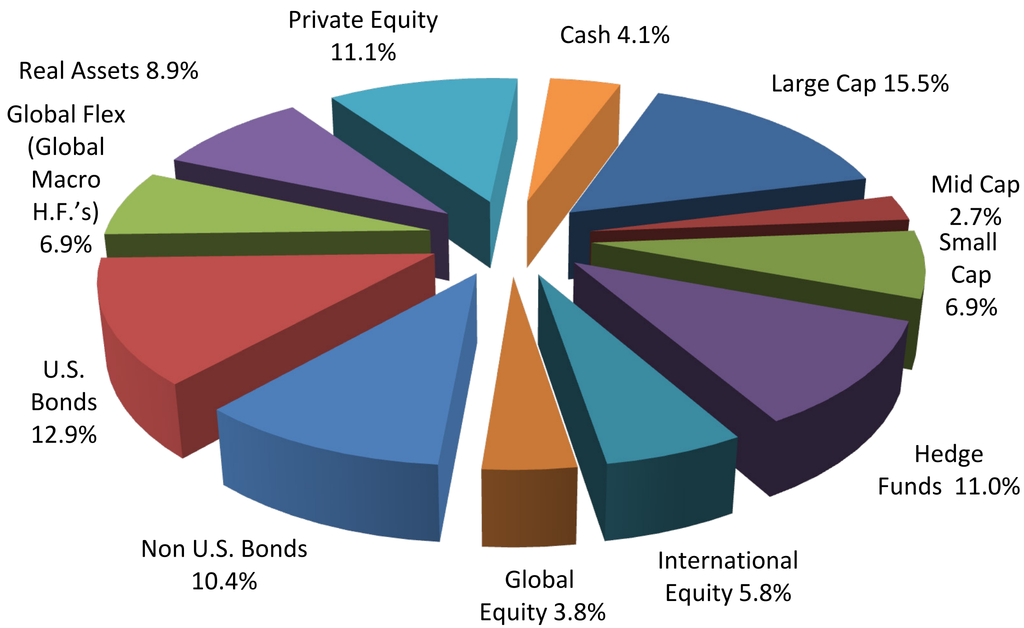
❖ Passive & Active are not mixed. In our LifeStage portfolio we only employ actively managed best of class strategies.



What are Participants choosing to invest in?

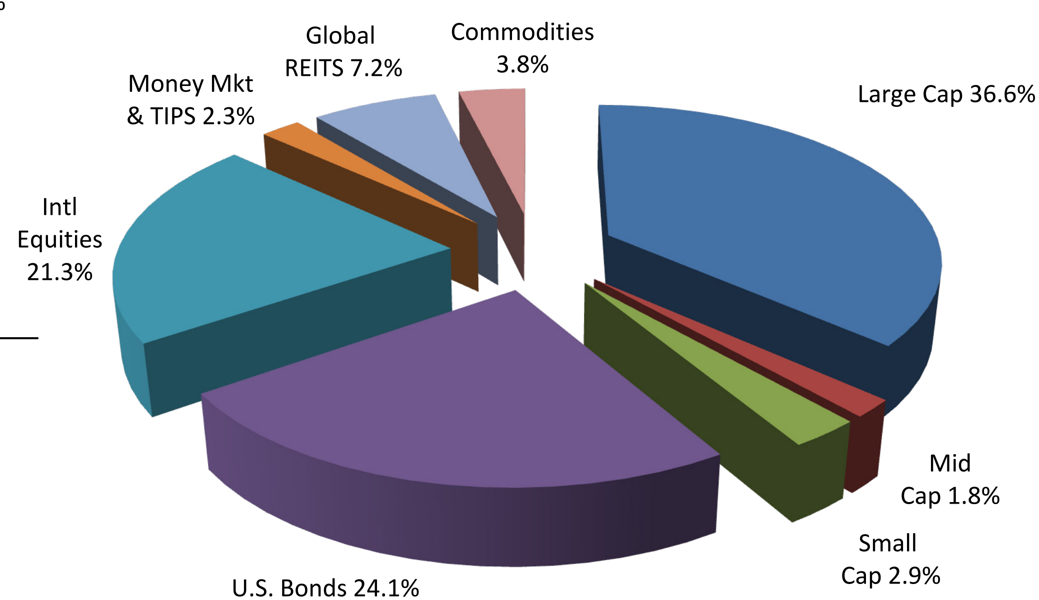


H-E-B BSRP Portfolio



- 100% Active Strategies employed
- No passive indexing
- Passive is 'Reserved' for other choices in plan. Mandate in this portfolio is for active management & active allocation (monitored & adjusted on the fly as needed)

Industry Leader Target Date 2035



- Industry accepted practice is for the manager to check & rebalance the fund every quarter (only rebalance if the assets are more than 2% their mandates target allocation).
- Majority of industry providers of Target Date Funds (TDF) employ 'Index Funds' or ETF's as the underlying diversifiers in their TDF's (to keep expense ratios lower & liquidity).

Long term.....Have our Participants benefitted?

- **General Fund (most popular with 62% of assets directed to this option) has returned 7.44% (net) vs. 8.18% for the S&P 500 for the last 10 years** (as of 8/31/14).
  - **Note- Equity like returns with only half of the amount of risk.**
- **Last 15 yrs= 6.73% vs. 4.78% S&P 500 net, *5.48% for a 60/40 blend of the S&P 500/BC Agg.*** (as of 8/31/14).
- **Ranked in first percentile when compared to peers in the Universe's (Endowment & DB) administered by Callan Associates Inc. (i.e. long term net performance adjusted for risk : 5 & 10 yr annualized etc).**
- **Capital preservation is emphasized.**
- **Note: Index options have significantly outperformed the active, balanced portfolios in the last 5 years. Potential change of the guard? To properly assess one needs to analyze within a full investment cycle which will include a market correction (which has not occurred in the last 5 years).**

What do we know?

- **Assets of the plan have doubled in the last decade after netting out contributions, company match and participant withdrawals. AUM currently = +$2 billion**
  - **More than 80% of those assets are invested in active management & the net returns are greater than that of the index options.**
- **The ability to manage risk cannot be ignored.**
- **Nationwide DC Plan Participant Survey: prefer a turn-key option with asset allocation to be managed by a professional. Majority want a balanced portfolio (target date or target risk) with not only active management but the ability to further diversify into alternative asset classes.**
  - **1 provider in DC space currently offering a full array of alternatives & actively managed strategies**
    - **Alternatives include: Hedge Funds, Private Equity, Real Estate, MLP's etc. (Turnkey = Enhanced Target Date Fund)**

REDHAWK WEALTH ADVISORS™

ERISA 3(38) Services

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Professional Background

- Over 25 years of experience in the retirement industry.
- Mercer – Partner with largest benefits consulting firm.
- KPMG - head consultant to Merrill Lynch.

  Retirement Plan Services – strategy, product and distribution.
- PAi – grew into a national firm - from less than 1,000 plans to over 14,000 plans and $3B in assets over 7 years.

Redhawk Overview

- Full-service RIA firm formed in 2005
- Headquartered in Minneapolis, MN
- ERISA 3(38) Investment Manager & Wealth Management
- $225M in AUM
- Fiduciary Lineups
  - Fee based with ETFs
  - Commission based with mutual funds
  - Professional money managers - tactical asset allocation portfolios
- Fiduciaryk – www.fiduciaryk.com

Full Fiduciary - Mitigating Risk

Low Risk ⟷ High Risk

Question	Redhawk ERISA 3(38) Fiduciary	ERISA 3(21) Fiduciary	Fiduciary	Benefits to Plan Sponsor
Accept liability for managing investment options?	Yes	No	No	Eliminates liability for managing investment options.
Have a vested interest in reducing investment plan risk and costs?	Yes	Maybe	No	Reduces investment plan risk and cost significantly.
Can a plan sponsor transfer significant risk?	Yes	No	No	Gets rid of significant risk.
Provide advice with accountability?	Yes	Maybe	No	Receives advice with accountability.
Have investment management discretion?	Yes	No	No	Discretion determines responsibility and liability.

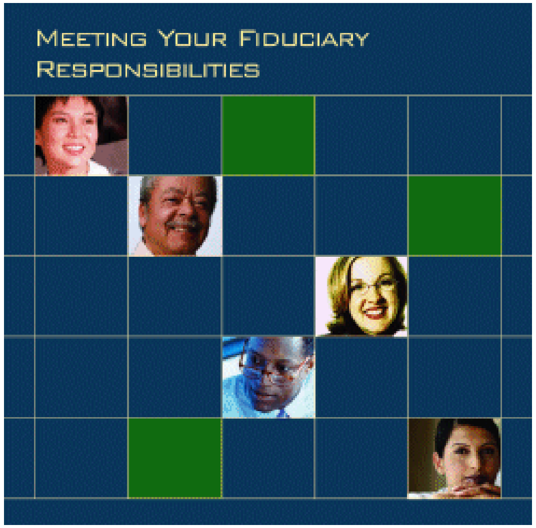
Under ERISA – Who is a Fiduciary?

Who is a fiduciary?

- Plan must have at least one fiduciary - plan administrator.
- Anyone exercising discretion in the administration of the plan.
- All members of administrative committee.

What are the responsibilities?

- Act solely in interest of participants to provide benefits.
- Carry out duties prudently.
- Follow the plan document.
- Diversify plan investments.
- Pay only reasonable plan expenses.
- Hiring and monitoring providers.



Fiduciary Liabilities

Fiduciaries are personally liable for plan losses caused by a breach of their ERISA fiduciary responsibilities and may be required to:

- Restore plan losses (including interest).
- Return ill-gotten gains.
- Pay the expenses relating to correction of inappropriate actions (e.g. appraisals, calculations).

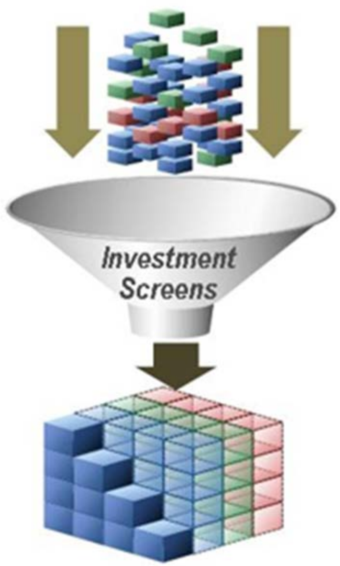
When Cogent asked “Retirement Planscape” responders about understanding plan fees, only 35% of sponsors at plans with less than $5 million in assets felt they understood their plan’s fees very well.

Investments - Center of Litigation

- ING - use of proprietary GIC fund
- Lockheed Martin – underperforming stable value fund
- Fidelity – recordkeeping costs
- Ameriprise – proprietary target date funds
- Fidelity – high priced Freedom Funds
- MassMutual – proprietary investments

REDHAWK WEALTH ADVISORS™

Redhawk Investment Committee



Investment Universe – Passive and active investments

Applying quanitative screens established in the Plan's Investment Policy Statement

Filter the "best in class" investment choices within each investment asset and sub-asset class.

Fiduciary Lineups

Fee Based

- Passive
- Blended
- Active
- Custom

ETFs
CITs

Commission Based

- 25bps
- 50bps
- Custom

Mutual Funds
CITs

Fiduciary Lineups

Fiduciary Lineups

Fee Based
- Passive
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ETFs
CITs

Commission Based
- 25bps
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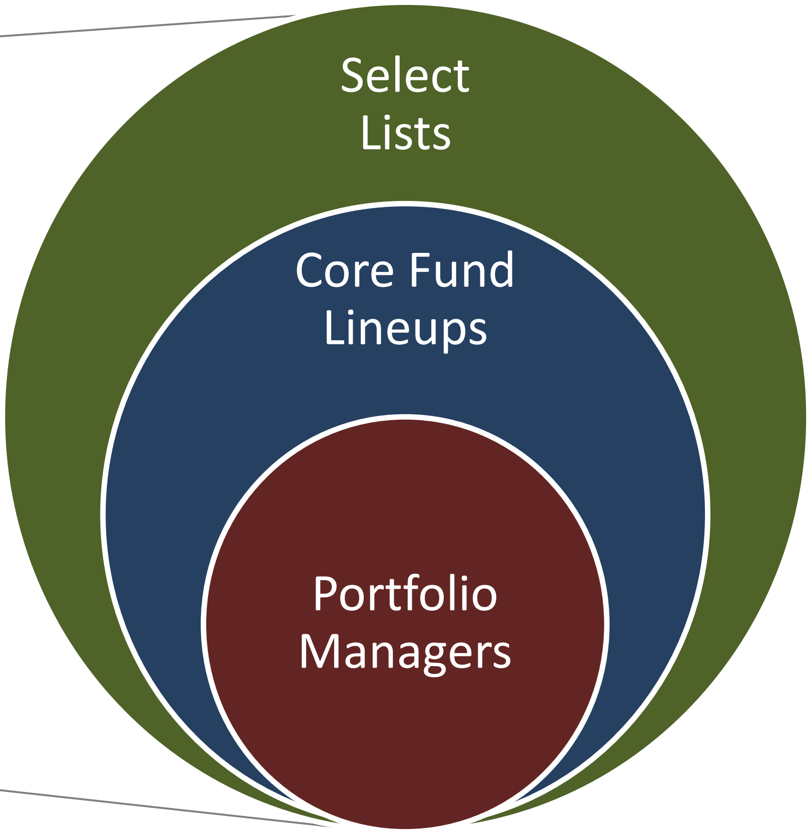
Mutual Funds
CITs



Use of Tactical Portfolios

SMAs

Endowments

403(b)
Non-ERISA

Qualified
Retirement
Plans

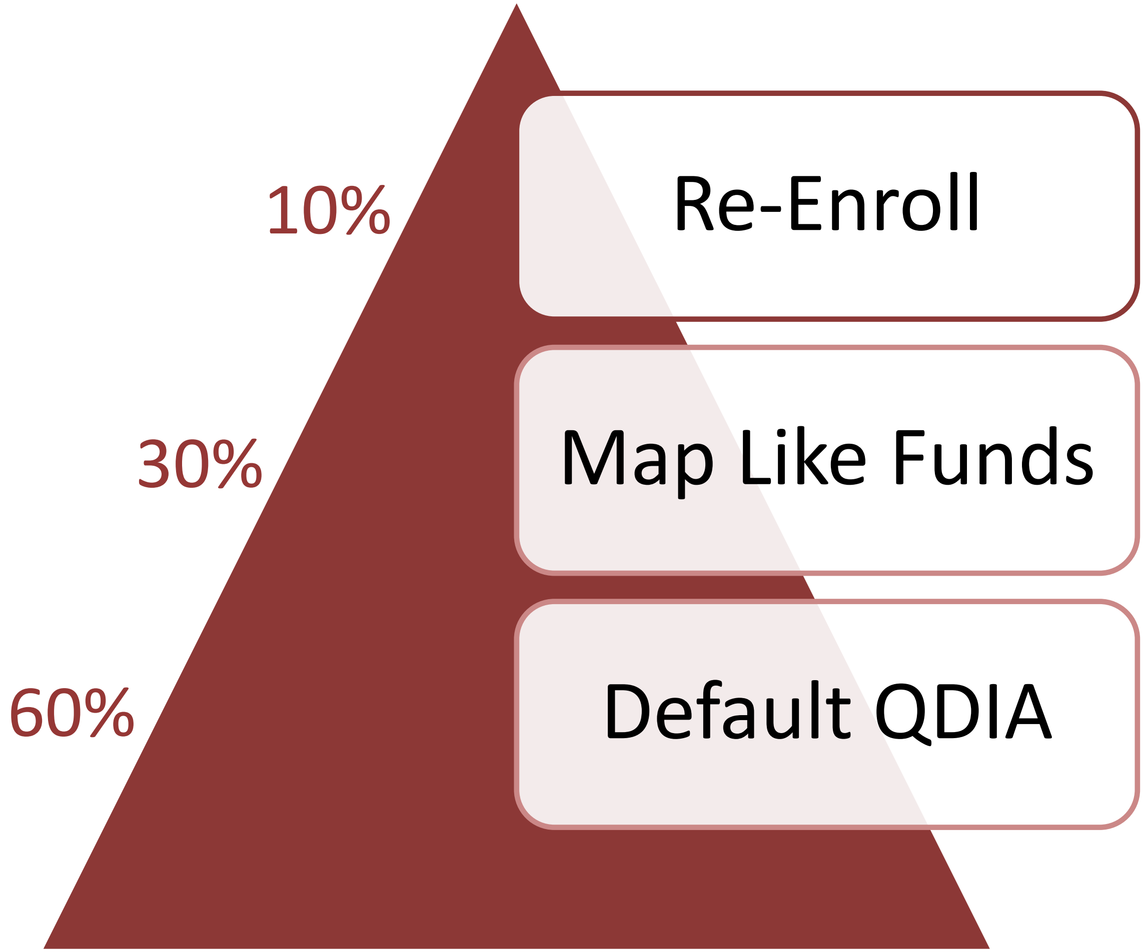
Professional Money Management

Better outcomes and growing at a fast pace…

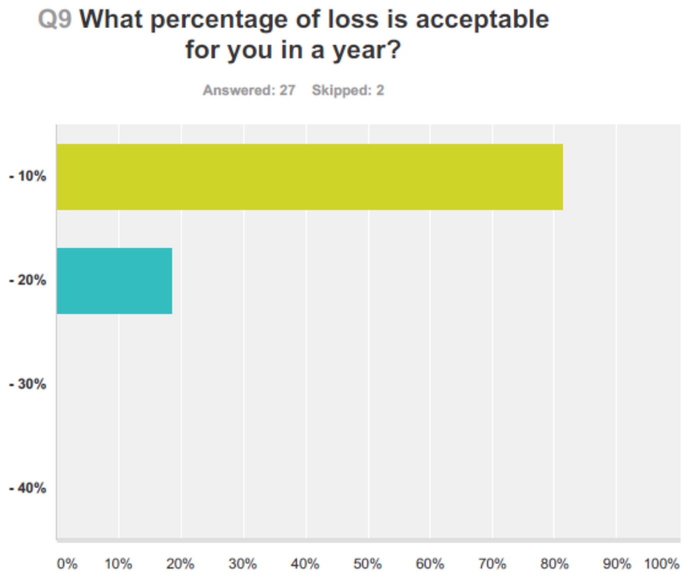
Realization that participants do not know the best way to allocate savings across various investments.

- A more personalized approach.
- Managed by a professional money manager.
- Offer fiduciary protection.
- 20.7% of plans offered managed accounts in 2008.
- 35.8% of plans offered managed accounts in 2012.

Enrollment Options

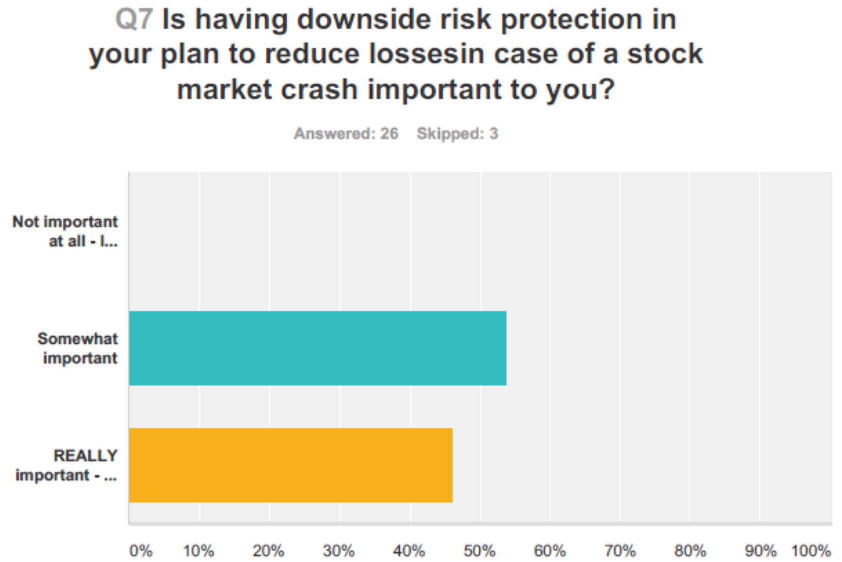


What's an acceptable loss…



Answer Choices	Responses	
- 10%	81.48%	22
- 20%	18.52%	5
- 30%	0.00%	0
- 40%	0.00%	0
Total		27

Downside risk protection is important to participants…



Answer Choices	Responses	
Not important at all - I don't care if I loss	0.00%	0
Somewhat important	53.85%	14
REALLY important - I don't want to loss!	46.15%	12
Total		26