CUSTOMIZATION

The journey toward individually optimized investment strategies

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Customization is the most sought after innovation in the domain of investment solutions. Customization at the individual investor level seems to be the leading edge of the competitive frontier and – therefore – the highest priority for providers. This certainly is the case in the retirement space, and especially so for defined contribution (DC) plans.

For decades, advanced customized investment strategies have been the norm for large institutional investors such as defined benefit (DB) plans, endowments and foundations. However, recent demand for investment solutions that increase the likelihood of successful outcomes for defined contribution plan participants has focused industry and public policy attention on this objective. Outcome based solutions are becoming increasingly sophisticated in their design and construction, and the next objective is to more precisely fine tune them to the profile of each particular investor.

Customization of investment strategies, even for non-institutional investors is not a new phenomenon. Trust companies have administered investments for wealthy individuals for hundreds of years. As the ranks of the mass-affluent have grown so have the number of investment advisors providing custom advice. But now there is increasing and urgent demand for sophisticated 'outcome based' investment solutions for all investors. This demand arises – at least in part – as a result of the structural shift from defined benefit to defined contribution plans. The shift has transferred responsibility for portfolio management from institutional professionals to individual investors, the vast majority of whom have no relevant training, thus increasing the need for solutions that include embedded asset selection and allocation. The industry response to this structural shift is an ongoing journey, the current phase of which is Customization.

Target Date Funds

An early step in this journey was the development of target date funds. They introduced the notion of a 'multi-asset' product which included an embedded asset allocation strategy that shifted over time in response to the investor's changing capacity for risk. Customization in target date funds is expressed in the 'vintages' that enable the investor to select the fund that matches their risk profile with particular consideration for how it will change as their retirement date approaches.

Custom Target Date Funds

Custom Target Date Funds (CTDFs) are a subsequent point on that customization journey. Their design can be more specifically tailored to the profile of the DC plan's participants, accommodating differences in the demographics of the particular plan relative to the general population. Customization is also expressed in the implementation of the CTDF, using the 'best practice' of open architecture to achieve the optimal mix of asset classes, investment types and investment managers. Lastly, customization can be expressed in the execution of portfolio operations with sophisticated methodologies for cash allocation, rebalancing and trading.

White Label Funds

White Label Funds are another recent example of customization. Defined contribution investment options are typically branded with the name of the firm that manages and/or distributes them. 'White labeling' an investment option removes the brand name and thereby provides flexibility and agility for the plan sponsor to change managers more quickly if/when it becomes appropriate to do so. Another important expression of customization in white label funds is the ability to use open architecture and multiple underlying managers to create an option that is designed specifically for the profile of that particular plan. In addition, like custom target date funds, white label funds are increasingly 'institutional grade' as a result of greater portfolio diversification arising from open architecture, value adding alternative asset classes, and professionally designed and administered asset allocation practices. But even white label funds are just interim points on the customization journey.

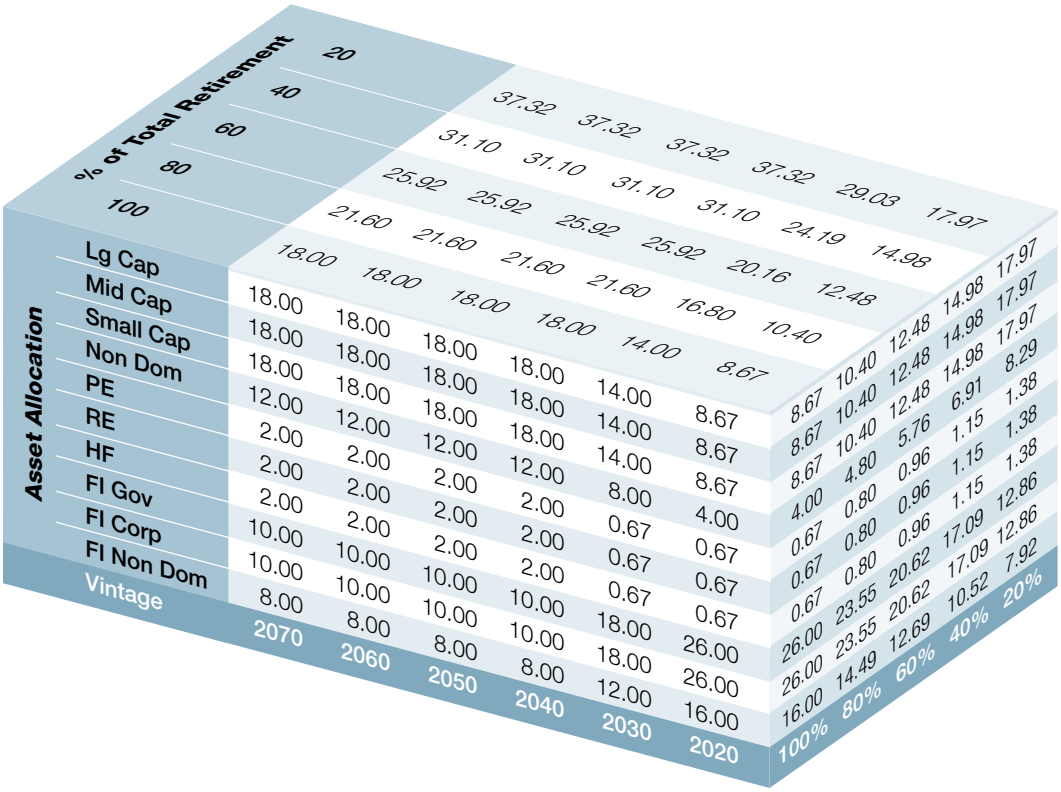
Managed Accounts

Managed Accounts are custom solutions. They are not new but the methods by which they are being delivered are evolving, and the market's focus on them has increased, in part as a result of being designated a Qualified Default Investment Alternative (QDIA).[1] While traditional managed accounts continue as a mainstream – if 'high end' – solution, additional methods for their delivery are emerging through the blending of technology and behavioral science, including 'managed account platforms' that sit operationally adjacent to defined contribution recordkeeping systems. The customization is based on information provided both by the plan sponsor and collected through on-line inter-action between the managed account platform and the investor resulting in a customized asset allocation model and implemented with the plan's investment options.

Robo-advisors

Robo-advisors came onto the scene recently and have rapidly proliferated. They provide mass market customization in the form of retail investment solutions. The customization is based on an online interview that collects information to create the investor's profile, and might include the investor's defined benefit and defined contribution plans, IRA's, savings and investments from other sources, as well as the investor's age, current and projected income, current obligations, future spending and retirement income objectives. The online interview and profile building tools developed by robo advisors have substantially raised expectations for what is possible in terms of specifying the investor's asset/liability profile – thus advancing the customization journey. However, the investment solutions themselves, while efficient (low cost for good products), are not truly 'institutional' in either the forms of investment (Mutual Funds and ETF's) or the breadth of the included asset classes when compared with the investment structures utilized by institutional investors.

Notwithstanding the valuable progress delivered by each of these steps, there is yet further to travel on this customization journey. However, from this point forward, care must be taken. Customization should continue where it adds value – such as in the further institutionalization of investment structures – but be constrained where it does not. 'Cohorts' are an essential design element in this calculus.



This graphic illustrates a series of target date funds and the respective asset allocation of each, with a second dimension reflecting the percentage of the investor's total retirement savings that is invested in this product.

Cohorts

Cohorts of investors can be devised on any number of factors. They can be based on years of age: 0-10, 11-20, 21-30 and so forth, such as in target date funds. However, multiple factors could be used in combination to create more specifically defined cohorts, thus achieving more finely tuned customized solutions.

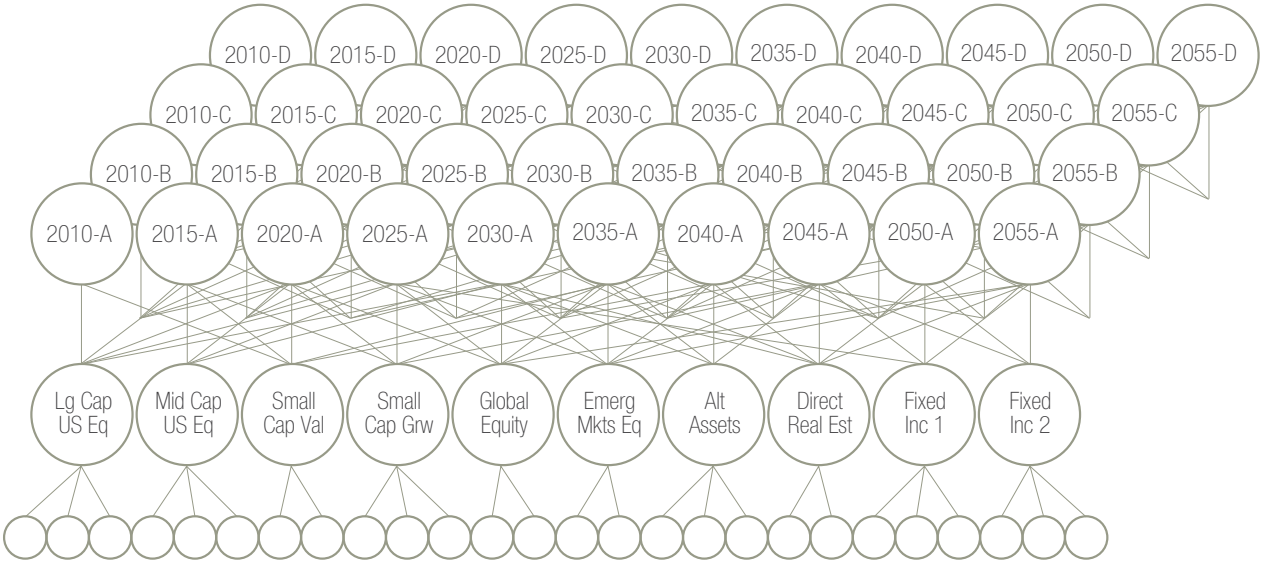
Most investment products are designed for a single cohort that includes all investors. However, the market seems to aspire to a unique product for each individual, or a 'cohort of one.' However, the incremental value of that degree of customization quickly reaches its marginal limit. It is not likely that the incremental value of creating and operating millions of distinct custom solutions can offset the cost. It is more efficient (considering both value produced and cost incurred) to design for cohorts of investors, if those cohorts are sufficiently fine-grained and fine-tuned.

Target date funds provide a conceptual example of customizing for cohorts. The cohorts in a series of target date funds are organized on the investor's retirement date. That essential design concept can be extended to create more granularly customized solutions by using additional factors to create a multi-dimensional matrix with each dimension reflecting another factor in the profile, such as (i) the percentage of the investor's total projected retirement income that is represented by this investment (e.g. 20%, 40%, 60%, 80%, 100%), and (ii) the percentage of that total retirement income that is effectively annuitized, such as from a defined benefit plan or Social Security income. Using more fine-grained and finely tuned cohorts enables the reduction of the number of unique solutions from potentially millions, to perhaps a few hundred and still producing the optimized solution.

On the other hand, the value that arises from increased customization in the form of the institutionalization[2] of the investment structure can offset the attendant cost, if the operating model and technical platform are both robust and efficient. This principal has been demonstrated in custom target date funds in which unitized, multi-tiered, multi-asset, open architecture investment structures deliver positive outcomes relative to non-institutional investment structures. It is in this context that customization should be increased to realize the portfolio manager's design

[1] Managed Accounts, Target Date Funds and Balanced Funds were all designated as QDIAs by the Department of Labor's Pension Protection Act of 2006.
[2] For further discussion of 'institutionalization' see the Milestone Group paper, "Complexity, the barrier to the institutionalization of DC investment options"

COHORTS



to the greatest extent possible, thereby liberating the value creation capacity to deliver the most successful investment outcome.

Therefore, the combination of constrained customization through the use of cohorts with unconstrained customization in the form of advanced investment strategies delivers the optimal value in product design.

However, in the past, legacy technology platforms and operating models have limited what is possible in practice because the cost and risk of operating these complex institutional investment structures have overwhelmed the value that is created, except for the largest institutional investors. Again, in the past, attempts to push through those cost and risk constraints have relied on desktop solutions to bridge the gap from the front office where the products are designed and managed, to the middle office where they are operated and controlled, but those desktop solutions are too narrow and frail to scale a business. However, the emergence of a more robust, efficient and comprehensive solution has transformed what is possible, and therefore, the competitive landscape.

Milestone Group's Multi-Asset Solution enables the flexible yet precise implementation and operation of complex pooled investment structures, such as custom multi-asset managed allocation strategies, including the use of operationally challenging (e.g. alternative) assets. This changes the calculus of what is possible and for whom it is commercially feasible. This solution is built for purpose to understand and operate pooled investment structures with the flexibility and control necessary to deliver all of the value designed by the front office. With that platform as the foundation, Milestone Group's Multi-Asset Solution extends from the middle office into the front office to put the levers for innovation and agility into the hands of the product developers and portfolio managers.

This solution makes the most advanced business, portfolio design and operating objectives achievable, enabling firms to leverage their proprietary intellectual property, pursue a disruptive strategic path, seize share in a vast and growing market, and capture substantial commercial reward for leading the industry in the creation and delivery of customized solutions.