PGIM

PART 1

THE EVOLVING DEFINED CONTRIBUTION LANDSCAPE

THE EXPANDING ROLE OF OCIOs

PGIM CANVASSED MORE THAN 130 DC PLAN SPONSORS AS WELL AS THE LEADING DC OCIO PROVIDERS TO LEARN ABOUT THE CURRENT TRENDS IN THE DC OCIO MARKET

An introduction

The Defined Contribution (DC) market is evolving and many plan sponsors are looking at innovative solutions to support their participants' retirement savings needs. Yet, many sponsors are looking for further support to help them implement and are thus evaluating OCIO (Outsourced Chief Investment Officer) solutions. The use of OCIOs in the DC market remains an evolving area in terms of both services provided and desired, and adoption is in the early days with more interest from mid-size DC plan sponsors. The goal of our research into this area was to capture insights and to offer a window into the current landscape of the OCIO arena to help better inform DC plan sponsors, DC consultants and OCIO managers alike. It's also instructive to understand the beliefs of OCIO providers in designing and implementing DC Plans. In this report we summarize what we learned from our research. We hope you find it valuable.

The role of an OCIO

An OCIO is a discretionary investment manager that shares fiduciary responsibility with a retirement plan sponsor related to the investment portfolio.[1] While OCIOs have historically been used by Defined Benefit (DB) plan sponsors and endowments, there is a growing trend of DC plan sponsors turning to OCIO managers. The reasons for the use of an OCIO for DC sponsors are varied but typically relate to constraints on the sponsor's time, limited resources and fiduciary concerns.

How we conducted our research

PGIM canvassed more than 130 DC plan sponsors to learn about the current trends in the DC OCIO market. The research was conducted by Greenwich Associates using an online, quantitative approach with DC plan sponsors who have at least one 401(k) plan and a minimum of $100 million in 401(k) assets. We also partnered with Curcio Webb, an OCIO search consultant, to survey OCIO providers. The 20 OCIO managers surveyed represent $16.8 trillion in total assets under advisement and $1.2 trillion in OCIO assets of all plan types. See an explanation of our methodology at the conclusion of this report.

This is the first in a three-part series from PGIM taking a deep dive into key trends in the DC space in the United States and contains analysis specific to the United States.

*Source: Cerulli Associates, White Paper: OCIO at an Inflection Point, March 2019. Data as of 12/31/19.

STATE OF THE OCIO MARKET

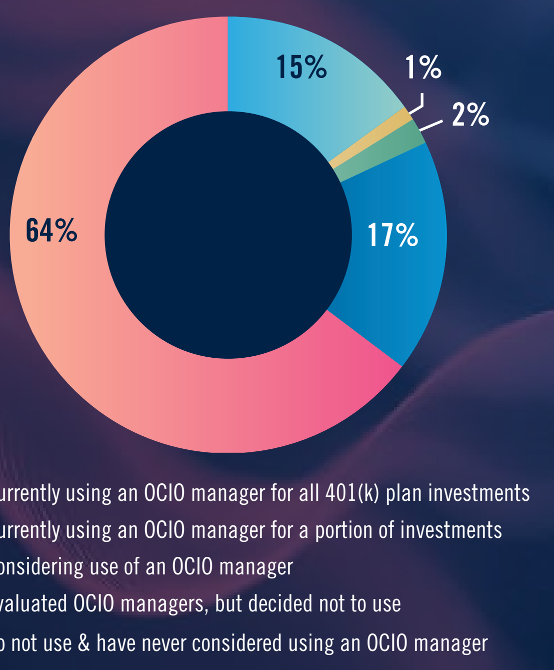
WHO IS USING AN OCIO?

The OCIO space continues to see growth across different markets, with an increasing number of firms offering services, primarily dominated by consulting and advisory firms, asset managers and some standalone OCIO managers. Indeed, Cerulli has predicted continued strong growth in the OCIO industry, growing from approximately $1.1 trillion in US assets under management recently to nearly $1.7 trillion by 2023. OCIO in DC, while not as large as other segments, is one of the fastest growing areas.*

According to our survey, use of an OCIO manager is most common in DC plans with $250 million to $500 million in 401(k) assets, and fewer large plans say they are currently considering OCIO as an option.

Legally, an OCIO will take a discretionary role for investment decisions from the plan sponsor for some or all of the investments in the plan.

STATUS OF USING AN OCIO MANAGER FOR THE 401(K) PLAN



DC PLAN SPONSORS' TOP REASONS FOR DECIDING TO USE AN OCIO

	1	2	3	4	5	6
DC plan sponsors' top reasons for deciding to use an OCIO	Desire for expertise in implementing institutional-quality structures	Perceived mitigation of fiduciary risk	Insufficient investment sophistication	Limited investment committee time	Not enough resources on investment staff	To lower overall costs
Top reasons from OCIOs' perspective	Perceived mitigation of fiduciary risk	Not enough resources	Limited investment committee time	Gain efficiencies of scale	Not enough investment sophistication	Desire for expertise implementing institutional-quality structures

TOP REASONS FROM OCIOs' PERSPECTIVE

RISK, TIME AND COMPLEXITY

Of the DC plan sponsors we surveyed,16% currently use an OCIO manager for some or all of their 401(k) plan investments (17% have evaluated OCIO managers but have decided not to use them). The most common reasons DC plans cite for using OCIOs are the desire for expertise in implementing institutional-quality structures and the perceived mitigation of fiduciary risk.[2] Unfortunately, litigation risk has often deterred sponsors' willingness to implement institutional and innovative investment solutions for their DC plans. This includes adding diversified asset classes and having a thoughtful mix of active and passive.

Interestingly, the top reason identified by plan sponsors (a desire for a more institutional approach) was cited last by OCIOs as a reason for getting hired. Indeed, when surveyed, OCIOs themselves say perceived mitigation of fiduciary risk is the primary reason they are hired, with 55% of OCIOs citing that concern as one of the top two reasons. OCIOs also cited sponsors not having enough resources (45%) as well as limited investment committee time (35%) as other reasons they are hired by DC plans. Given the dichotomy in responses, it appears OCIOs may not fully appreciate the desire of plan sponsors to implement institutional solutions.

The third most-cited reason by plan sponsors for engaging an OCIO is the inability of plans to implement more complex programs as a result of a lack of expertise and resources, suggesting many plan sponsors who want to implement more thoughtful approaches need expertise and fiduciary support to do so.

Breaking this down further by size, larger plans (over $500 million) were more likely to cite the desire for institutional investments and the lack of investment committee time, as they likely feel more comfortable with fiduciary risk and their ability to dedicate internal resources. Smaller plans are more focused on mitigating fiduciary risk and the lack of internal investment sophistication and resources.

OCIO PERFORMANCE

SATISFACTION WITH OCIOs IS HIGH

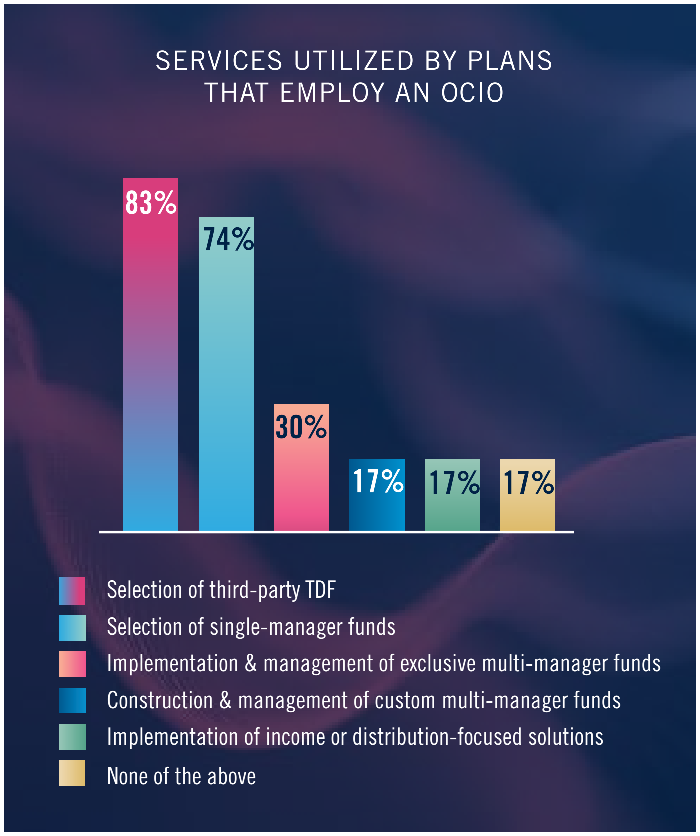
Overall, a large majority of plan sponsors (74%) are extremely satisfied with their OCIO manager, and none are dissatisfied, according to our survey. For those sponsors that haven't hired an OCIO, the most common reasons cited were wanting to maintain control of investments and the belief that they have the internal expertise to do so, particularly for plans with over $500 million in assets.

Of those sponsors who use an OCIO, just 26% hired a consultant to help them with the selection, and it was more common for smaller plans. Most OCIOs have either flat fee or asset weighted fee structures, although most clients surveyed use flat fee.

OCIO UTILIZATION

OCIOs OFFER A WIDE RANGE OF SERVICES

Most of the OCIO providers will take discretion on the hiring and firing of investment products from asset managers, including single asset class fund and off-the-shelf target date funds (TDFs). Most plan sponsors who utilize an OCIO leverage these services for single-asset-class funds and target date funds.



For efficiency, some OCIO firms will create their own vehicles, both for asset class funds and TDFs in which their OCIO clients can invest. These are often multi-manager funds. A large majority of OCIO firms will also implement a custom multi-manager fund or a custom target date fund for clients, although this service is not as frequently utilized by surveyed plan sponsors.

Besides the discretionary services, most OCIOs offer several ancillary services including investment menu design, vendor reviews, investment education, plan design support and participant communications. A majority of surveyed plan sponsors who use an OCIO said they take advantage of these non-discretionary services, with the exception of participant communications.

DIFFERING INVESTMENT VIEWS

IMPLEMENTATION OF OPTIONS

Fiduciaries, whether OCIOs or plan sponsors, often come to different decisions on how to implement their investment lineup. We looked at four key areas and compared what OCIOs prefer, relative to how plan sponsors implemented them, contrasting those that have hired an OCIO and those that haven't. The four areas are:

1. Active vs. Passive in the Core Lineup

Our research shows an overwhelming number of OCIO firms feel DC menus should be a mix of both active and passive. Plan sponsor respondents that don't use an OCIO tend to lean a bit more towards passive, most likely for their core asset class funds.

2. Active vs. Passive in the Target Date Fund

A smaller but still meaningful number of OCIOs prefer that target date funds are also a mix of active and passive. When looking at plan sponsors, there is less difference between plans that use an OCIO or not, although you see more usage of 100% passive for those who don't use an OCIO.

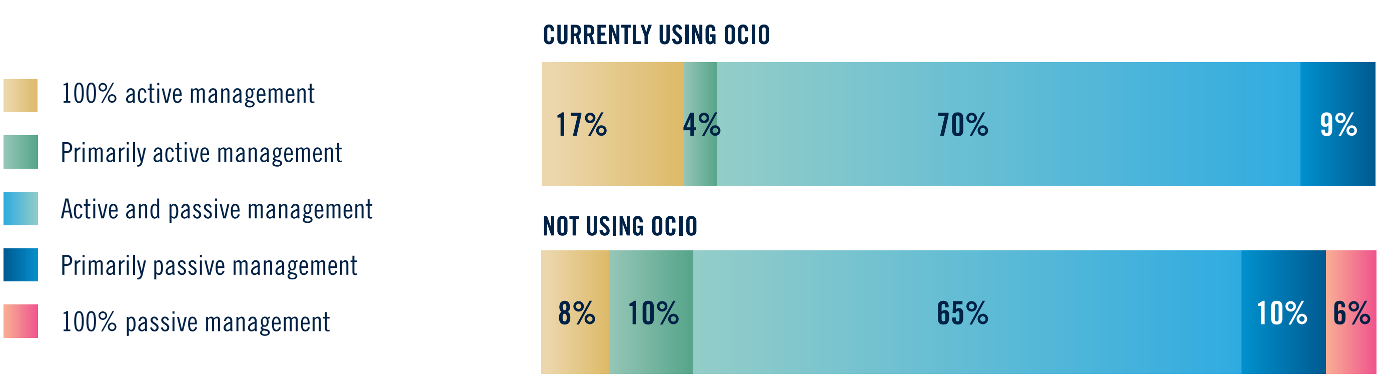
3. Use of Multi-Manager Funds

Some plans are using more multi-manager fund options to diversify manager risk. This seems to be somewhat preferred by OCIO managers, with only 25% disagreeing or somewhat disagreeing with the statement that they prefer that to a single manager.

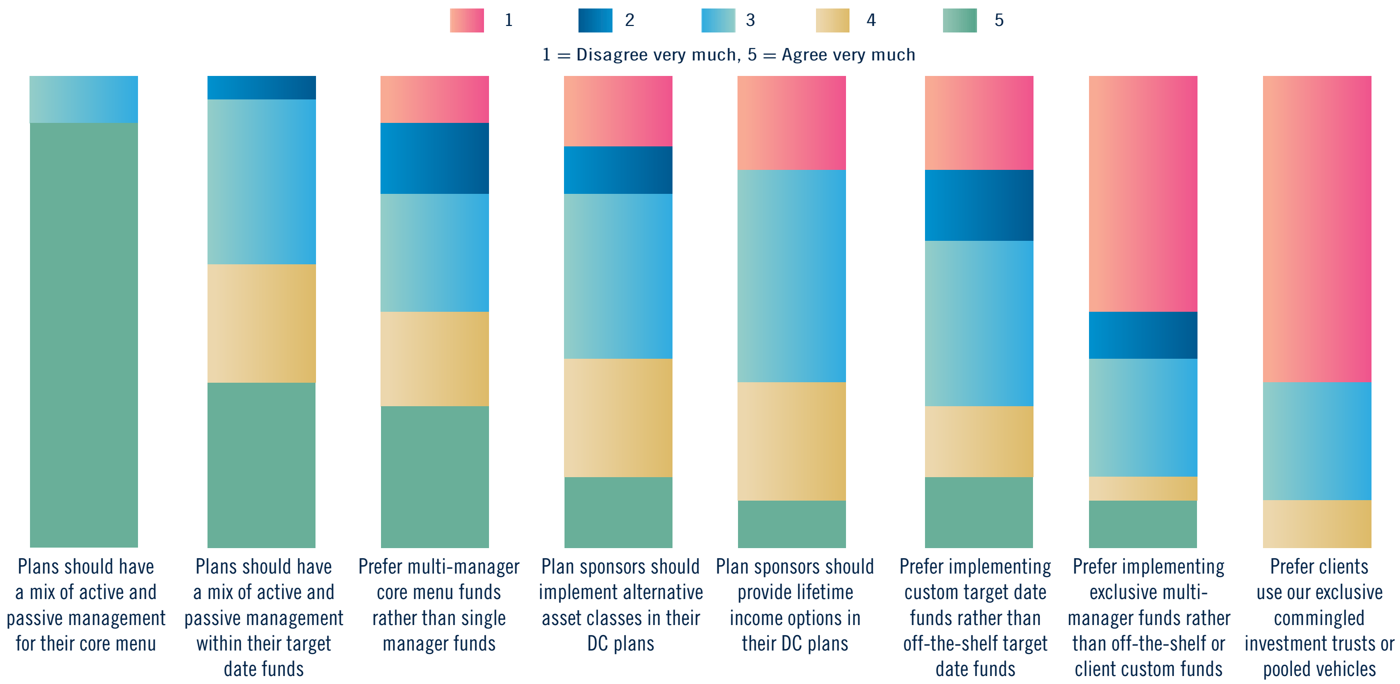
4. Alternative Investments

Meanwhile, although OCIO firms seem to be neutral to somewhat positive on the inclusion of alternatives in DC plans, our research doesn't show a meaningfully higher usage of these strategies for plans that utilize an OCIO manager. Part of the explanation for this may be that most OCIO usage is in the small to mid-market, where there is currently less use of alternative assets.

HOW ASSETS ARE INVESTED BY WHETHER THE PLAN USES AN OCIO OR NOT



VIEWS FROM OCIOs: LEVEL OF AGREEMENT FOR THE FOLLOWING STATEMENTS ABOUT INVESTMENT OPTIONS



Note: Due to small sample size (n=20), the results are for directional reference only.

AREAS OF OPPORTUNITY

ENHANCEMENTS WILL BE EVOLUTIONARY, NOT REVOLUTIONARY

Importantly, the recently passed SECURE Act contains two areas of focus that could intersect with the DC OCIO market: Retirement Income and Multiple Employer Plans (MEPs).

Changing demographics, activity in Washington, and the evolution of solutions are all spurring greater interest in retirement income. The next generation of retirement income solutions should include both guaranteed and non-guaranteed components, along with access to a wider and more diversified set of asset classes and greater technological customization.

The question is: will there be meaningful action in this area? Interest is likely to grow, but sponsors may need help getting to the implementation stage.

Meanwhile, the SECURE Act also allows unrelated small employers to band together in “open” 401(k) MEPs, also referred to as Pooled Employer Plans, or PEPs. Currently, 75% of DC plan sponsors think it is extremely unlikely that their organization will join. While our research didn’t specifically ask OCIO providers about open MEPs, we expect many to see this as a natural extension of their OCIO business.

The safe harbor provisions related to lifetime income in the SECURE Act should be helpful, but perhaps structures such as MEPs will more effectively bring the needed innovations to American workers.

CONCLUSION

WILL OCIOs FILL THE GAP TO PROVIDE INNOVATIVE SOLUTIONS?

The move by some plan sponsors to utilize OCIOs seems to be driven, in part, by the desire to implement more best practices. For example, leading plan sponsors are looking to improve outcomes by offering a more institutional approach, which includes a thoughtful mix of active and passive management and the use of diversifying asset classes. It’s also notable that this institutional mindset is aligned with most OCIO providers’ preferences when they take on a discretionary fiduciary role. That said, some sponsors remain concerned with the perceived fiduciary risk of implementing such an approach, despite understanding the benefits, while others want to do so but need help getting there. Of course, addressing fiduciary concerns by merely offering only low-cost basic options could violate one’s fiduciary duty to do what’s in the participant’s best interest, not what’s in the plan sponsor’s best interest. Many also realize that a purely simple investment approach isn’t likely to lead to better outcomes over the long term, so there are continued opportunities for OCIOs to fill the gap, to innovate and to provide more solutions.

For more info contact Josh Cohen, Head of Institutional Defined Contribution, PGIM Institutional Relationship Group at josh.cohen@pgim.com or learn more at pgim.com/dc

APPENDIX

METHODOLOGY

- The research was conducted by Greenwich Associates from March 5th to July 17th 2020, using an online, quantitative approach with DC plan sponsors in the United States who have at least one 401(k) plan and at least $100m in 401(k) assets.
- The research was conducted on an unsponsored/blind basis with no mention of PGIM as the study sponsor.
- Participants were incentivized to participate with a summary of the research findings as well as a charitable donation to the American Red Cross or AMEX gift card ($100).
- Respondents had the option to determine whether to disclose their participation and/or individual responses.
- An additional 5-question survey of 20 OCIO managers was conducted by Curcio Webb from fall 2019 to summer 2020. These OCIO managers represent $16.8 trillion in total assets and $1.2 trillion in OCIO assets (all plan types).

Figure A1: Use of an OCIO manager is most common with DC plans with $250m to $500m in 401(k) assets and fewer large plans are considering it as an option

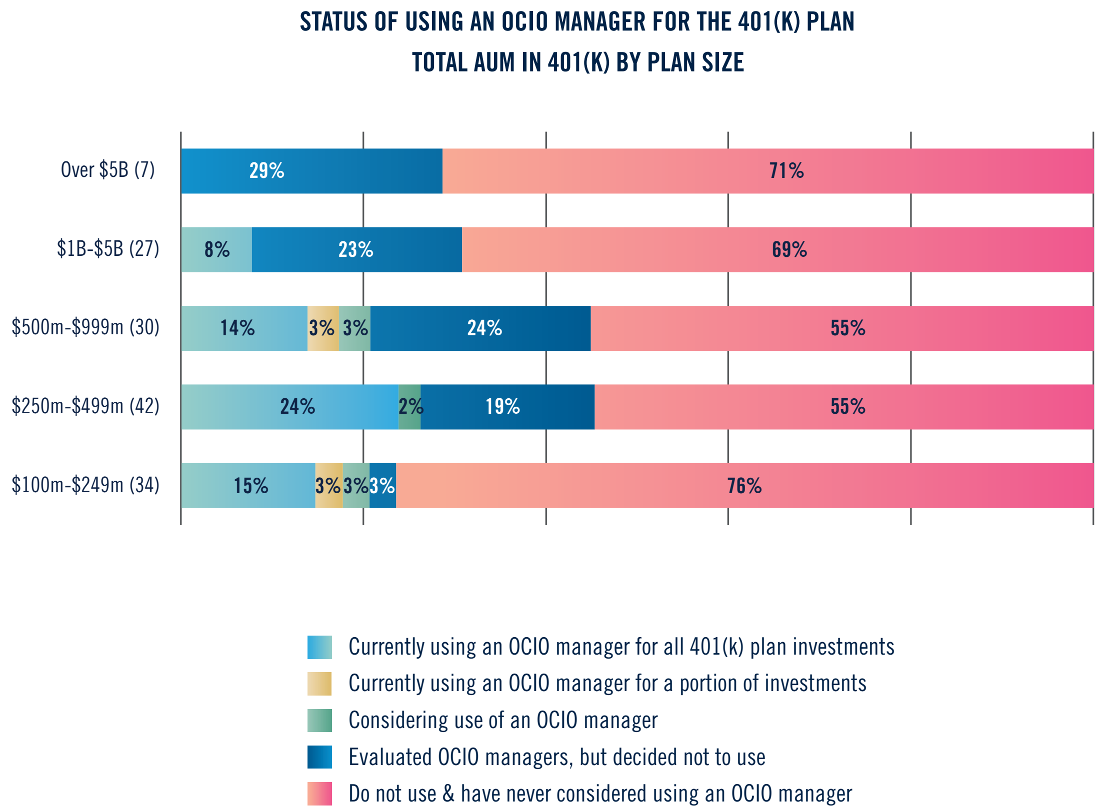


Figure A2: DC plan sponsors cite expertise in implementing institutional-quality structures as well as perceived mitigation of fiduciary risk as their top reasons for hiring an OCIO

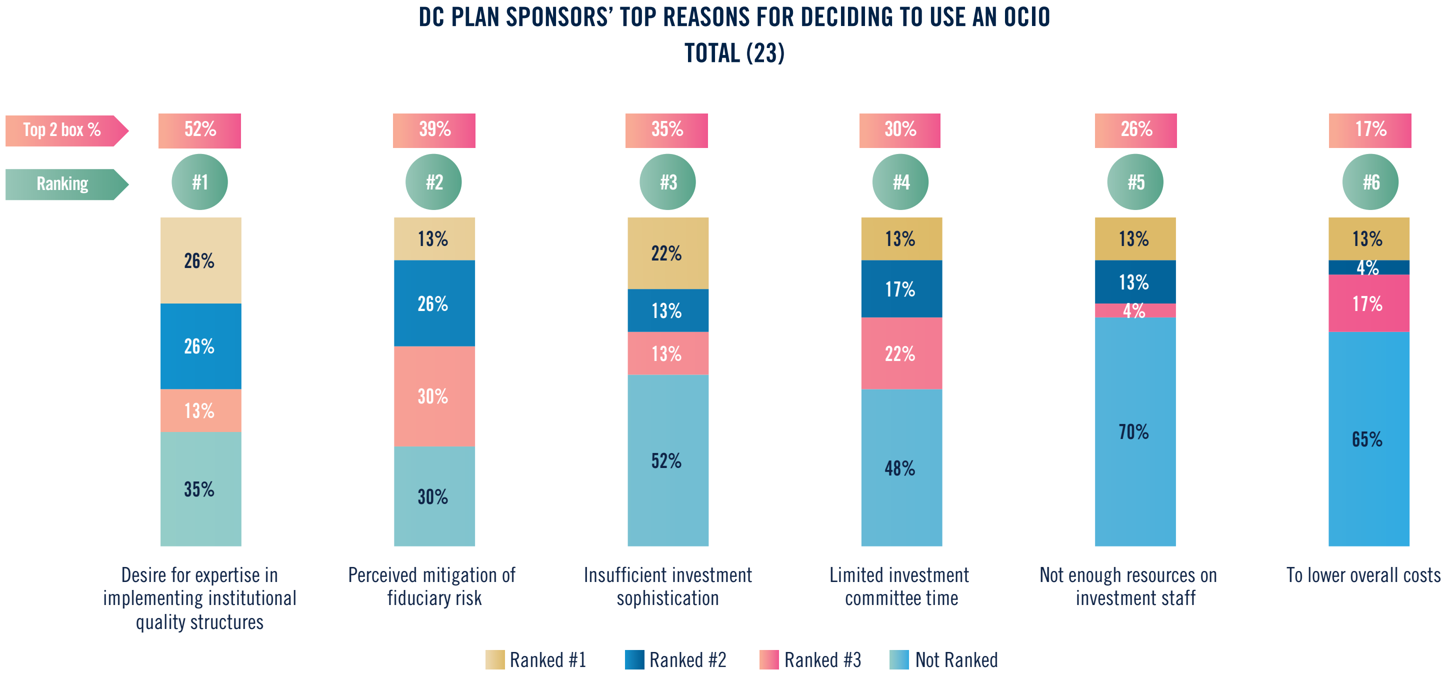


Figure A3: From the OCIOs' perspective, perceived mitigation of fiduciary risk is the primary reason they are hired by DC plans, along with limited resources and time

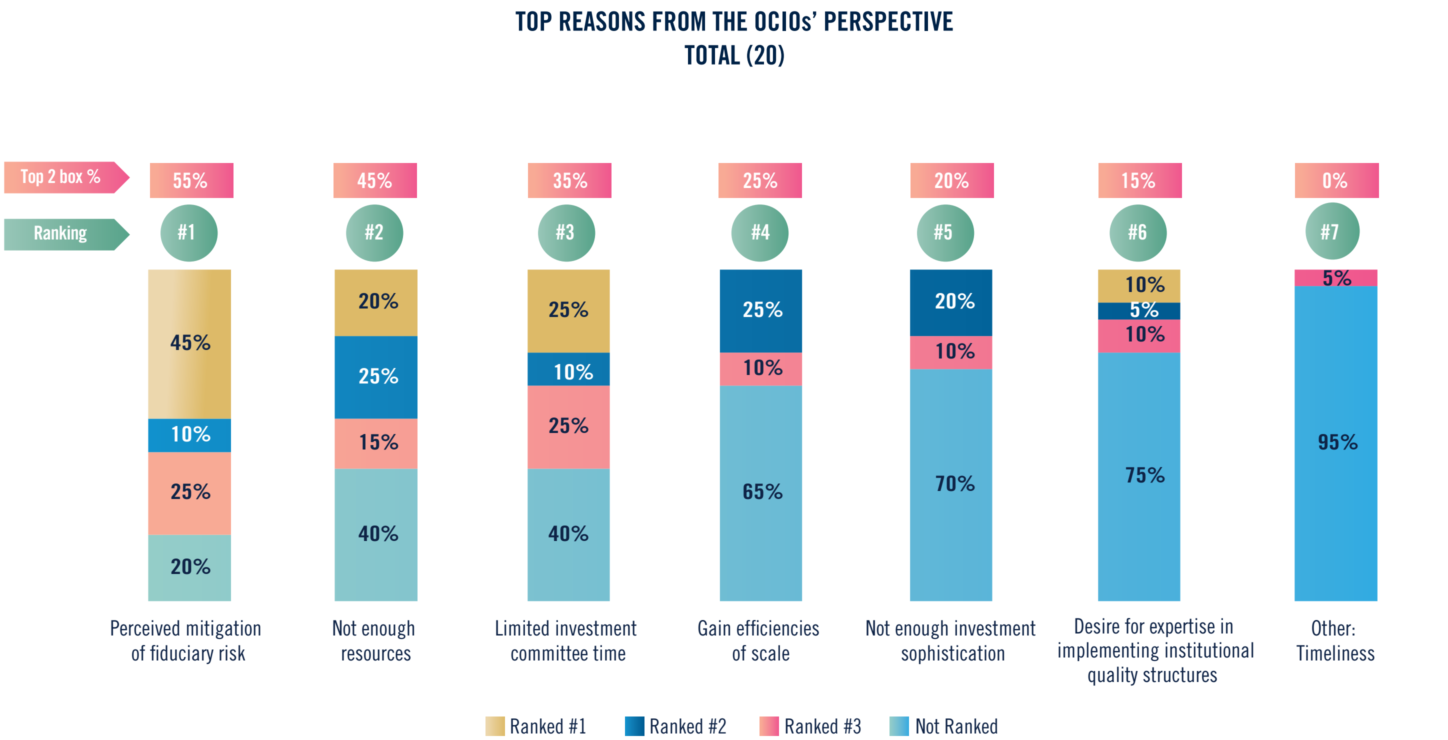
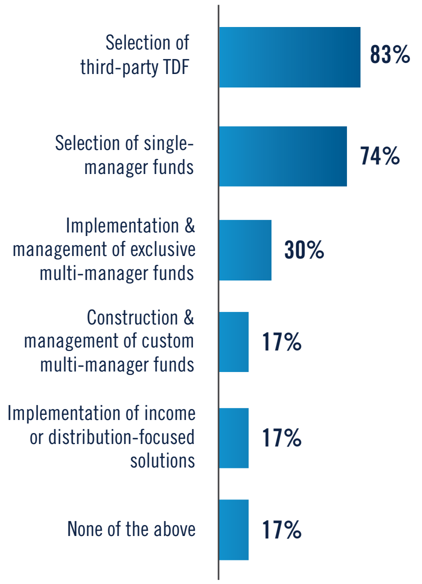


Figure A4: The most common service provided by OCIO managers for the core menu is the selection of single-manager funds

TOTAL (23)



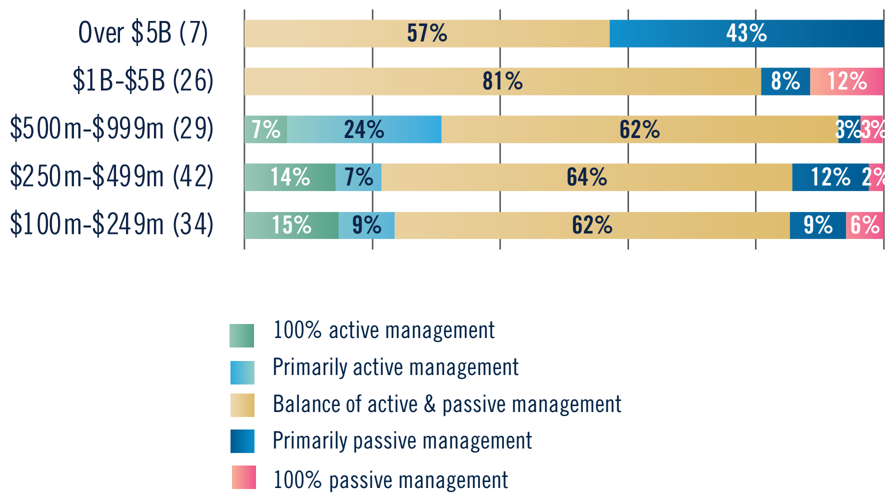
TYPE OF OCIO SERVICES PROVIDED BY PLAN SIZE FOR CORE MENU

TOTAL AUM IN 401(K) BY PLAN SIZE			
$1B to $5B (2)	$500m to $999m (5)	$250m to $499m (10)	$100m to $249m (6)
100%	100%	80%	67%
50%	100%	60%	83%
50%	20%	30%	33%
50%	40%	10%	0%
50%	0%	30%	0%
50%	0%	30%	0%

Figure A5: Most DC plan sponsors offer a balance of active and passive investment options in their 401(k) plans

HOW INVESTMENT OPTIONS IN 401(K) PLAN ARE MANAGED

TOTAL AUM IN 401(K) PLAN BY PLAN SIZE



WHAT ERISA SAYS

[1] "OCIOs may refer to themselves as "3(38) managers." Section 3(38) of ERISA defines an "investment manager" as a fiduciary who has the power to manage, acquire, or dispose of any asset of an ERISA plan, and meets certain other criteria. Section 3(21) of ERISA defines the term "fiduciary" more broadly to include people and entities with the power to manage, acquire, or dispose of ERISA plan assets (this would include 3(38) managers), but also those who provide investment advice to ERISA plans for a fee, and those who have discretionary authority or responsibility over ERISA plan administration."

[2] "Appointing a 3(38) manager can insulate plan fiduciaries from liability for that manager's acts and omissions. Plan fiduciaries are still responsible for the selection and monitoring of the 3(38) fiduciary."

IMPORTANT INFORMATION