FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
77 K Street, NE Washington, DC 20002

April 9, 2013

MEMORANDUM FOR THE EXECUTIVE DIRECTOR

FROM: RENEE WILDER, Director, Office of Enterprise Planning

SUBJECT: Default Investment Fund Option

ISSUE

The Office of Enterprise Planning (OEP) was directed to examine changing the default investment option for new participants joining the Thrift Savings Plan (TSP). Currently, new Plan participants are defaulted into the Government Securities Investment Fund (G Fund) and remain invested in this fund until they make an election directing their contributions into one or more of the other funding options available in the TSP.

While the G Fund avoids exposure to credit risk and market price fluctuations, over time, the fund will likely underperform the equity markets and consequently have negative implications for participants who have longer investment horizons and could benefit from being broadly invested across the equity markets.

Examination of participant investment behavior indicates that a significant portion of defaulted participants are not actively making investment allocations. This inertia means their contributions remain invested in the G Fund and do not participate in equity market returns.

In examining the impact of changing the default investment from the G Fund to the age-appropriate Lifecycle Fund, a number of factors, including relevant legislation, industry trends and participant demographics were considered. This memorandum provides an overview of these factors and a recommendation to change the default investment from the G Fund to the age-appropriate Lifecycle Fund (L Fund).

CURRENT PROGRAM DESIGN

There are two principal sources of accounts that default into the G Fund. Under our authorizing statute, Federal Employee Retirement System Act of 1986, the Government Securities Investment Fund (G Fund) is the default fund for all newly enrolled participants, including those covered under the Federal Employees' Retirement System (FERS). Whether or not an individual elected to make contributions into the Plan, an

Agency Automatic 1% contribution is made for FERS employees. These contributions are defaulted into the G Fund and remain in that allocation until the individual makes a different contribution allocation.

Further, the Thrift Savings Plan Enhancement Act of 2009 enabled auto-enrollment of new Federal employees into the TSP. Consequently, since August, 2010, unless the individual actively elects *not* to participate in the TSP or to participate at a different deferral rate, all new federal employees automatically have 3% of their base salary contributed to the TSP. These contributions also default into the G Fund by law.

After the initial contribution is processed, the new participant is sent a welcome letter and instructed to provide contribution allocation direction to the TSP via the website or ThriftLine (telephonic). When received, the contribution allocation is adjusted to match the participant's instructions. If the participant does not provide allocation instructions, all future contributions remain defaulted to the G Fund.

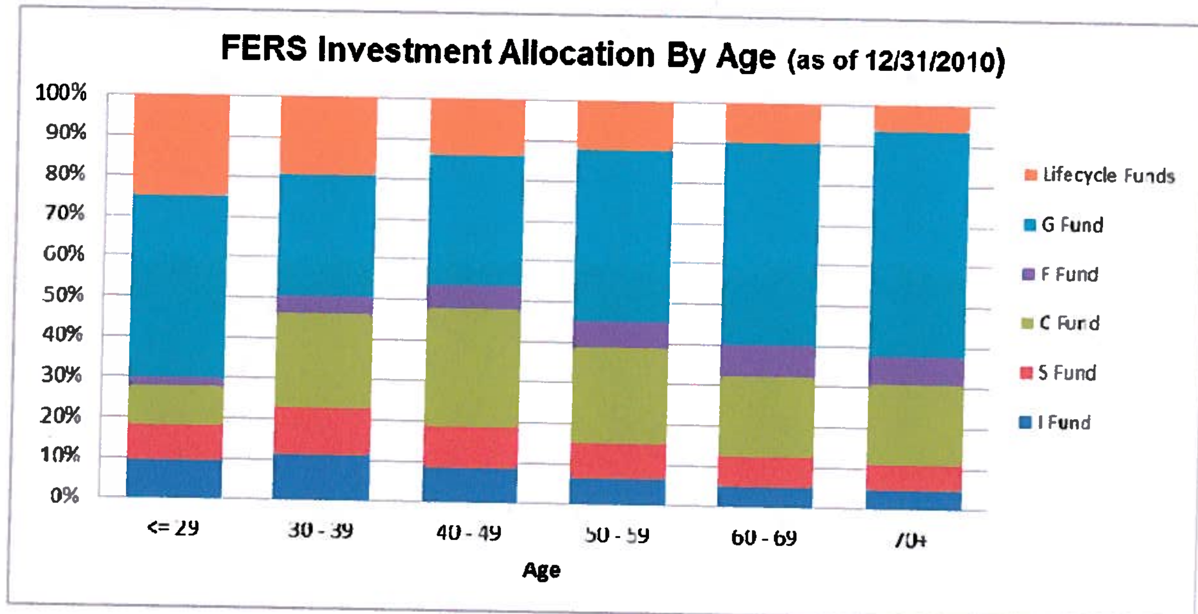
We have established 338,000 accounts under auto-enrollment since inception in August 2010 and of these 111,405 (33%) represent accounts which have not made an active contribution allocation.

PARTICIPANT DEMOGRAPHICS

We have examined recently compiled demographic data to provide additional insight into participant behavior.

In viewing figure 1, it is generally apparent that allocations to the G Fund (blue bar) appropriately increase as the age of the TSP's population increases. This behavior is consistent with the expectation that participants shift their investment allocation towards the relative safety of income producing assets as they approach retirement age. The noteworthy exception to this observation is in the grouping of participants aged 29 and under. In this age cohort, a disproportionate percentage (45%) of participants are investing in the G Fund.

Figure 1

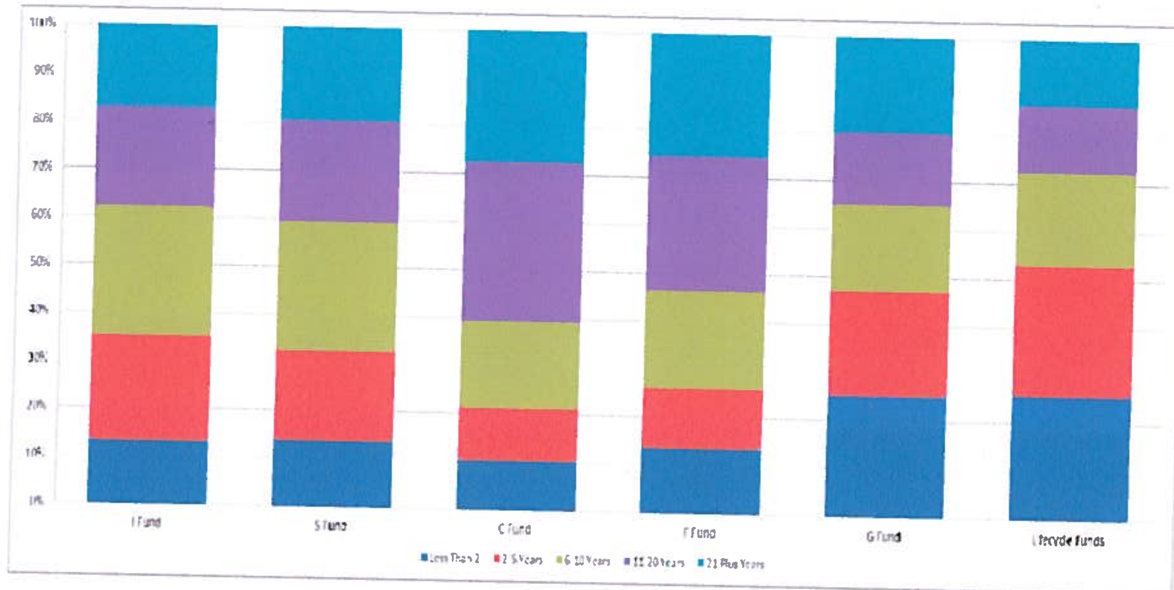


It is generally observed in the defined contribution markets that younger participants have a more difficult time envisioning their need for retirement saving and planning. This leads them to be less engaged and therefore less likely to actively manage their retirement accounts. If this group were invested in the L2050 Fund, the age-appropriate Lifecycle option for this cohort, their contributions would be allocated across the equity markets and include a smaller allocation to the G Fund. With about 35-40 years to retirement, this group has an investment horizon that should allow its members to participate in the markets and comfortably "weather" its cycles by assuming additional risk.

Changing the default option to an age-appropriate Lifecycle Fund would ensure that the contributions of TSP participants are invested in a Fund that gives them the best chance of being prepared for retirement. Lifecycle Funds, which allocate assets among the individual TSP funds, are designed to maximize expected performance for the amount of risk taken. Furthermore, the design of the Lifecycle Funds automatically address changing asset allocation needs (automatically becoming more conservative) as participants near their draw-down dates. Therefore, for long-term investors, which include the vast majority of newly hired Federal employees, the Lifecycle Fund may be a more appropriate default option.

We have further determined that the accounts largely invested in the G Fund are those of newer federal employees. Figure 2 illustrates the power of inertia earlier mentioned. The highest investment allocations for employees with two years or less of tenure has been to the G Fund and the Lifecycle Funds. The good news is that of those participants who do "engage" and make contribution allocations, newer employees are taking advantage of the L Funds. On the other hand, there is an equal portion of newer employees who do not engage and consequently remain fully invested in the G Fund.

Figure 2



In the 2006 Participant Survey, participants were specifically asked whether they thought participants who do not provide investment direction to the TSP should be defaulted to the L Funds or the G Fund. The survey findings showed that respondents were strongly in favor of defaulting to the L Funds. Overall, 49% of respondents preferred the L Fund as the default option, while 27% preferred the G Fund and the remaining 24% had no opinion.

If the L Fund default is adopted by the TSP, all newly-enrolled participants will have their contributions defaulted to the age-appropriate L Fund as determined by their agency-reported date of birth. In this model, age 62 is the assumed drawdown date for a participant's TSP account, and contributions will be defaulted to the L Fund with the time horizon that most closely matches the calculated drawdown date for the participant. For example, a newly-enrolled participant who was born in 1967 will reach age 62 in the year 2029. This participant would be defaulted to the L 2030 Fund and all contributions would be directed to this fund until the participant elected to change the allocation.

We have found that participants are most likely to make an investment allocation decision within the first quarter of becoming a TSP participant. However, this investment decision activity drops off significantly thereafter. It is also important to note that participants whose accounts are defaulted into a Lifecycle Fund will always be able to change the allocation to the G Fund or any of the other core investment alternatives.

INDUSTRY TRENDS

The passage of the Pension Protection Act (PPA) in 2006 provided a safe harbor for sponsors utilizing qualified default investment alternatives (which included target date funds) and thereby alleviated employers' concerns about fiduciary liability for market losses. This led to a meaningful uptick in the utilization of automatic enrollment and a similar shift in default funds from stable value to target date funds. AonHewitt reported in its 2011 Trends & Experience in Defined Contribution survey of 546 employers that 56% of the respondents automatically enrolled participants and that default investments under automatic enrollment shifted to qualified default investment alternatives (QDIA) options, with target-date portfolios dominating. "Currently, 78% of plans default participants' funds into a target-date fund, up from 69% in 2009 and 50% in 2007. Balanced or target-risk funds are used with 13% of plans, managed accounts by 3%, and stable value or money market by 6% of employers."[1] It should be noted that 25% of employers that participated in the AonHewitt survey were ranked as Fortune 500 companies.

Similarly, Deloitte reported in its 2011 Annual 401K Benchmarking Survey that 77% of respondents used lifecycle and target retirement date funds as the default investment option. The Plan Sponsor Council of America (PSCA) survey illustrates the same market trend as its 2007 survey reported 48.7% of respondents using target retirement date

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[1] *2011 Trends & Experiences in Defined Contribution Plans – Paving the Road to Retirement.* AonHewitt. Pg. 6. 2011.

funds for the default investment option. That percentage increased to 69.7% in the 2011PSCA survey.

INVESTMENT CONSIDERATIONS

When the Board was considering implementation of auto-enrollment, it also was considering changing the default investment to an age-appropriate L Fund. However, at the same time, the U.S. financial markets were in considerable turmoil and there was reluctance to default participants into any option that might present risk to their capital investment. Consequently, the Board chose not to recommend enactment of an L Fund default provision.

It is valuable to examine illustrative investment returns for the G Fund versus L Funds since the inception of the L Funds and since the implementation of auto-enrollment. Figure 3 compares returns of the L Funds since their inception in August 2005 to the G Fund over the same period.

Figure 3

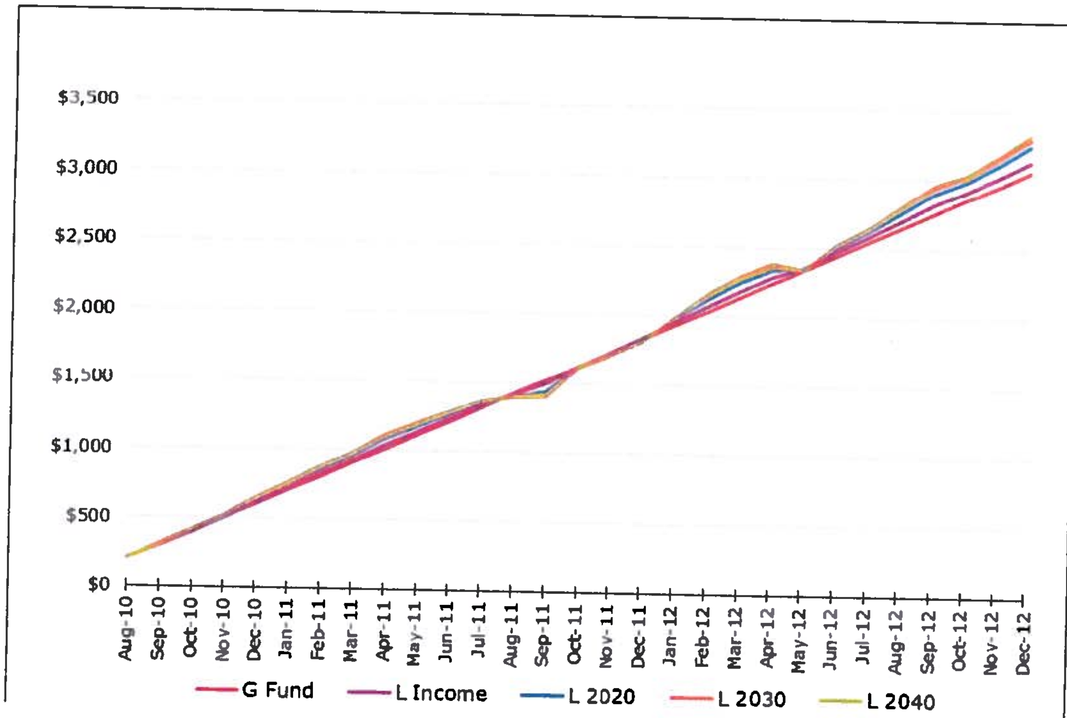
Fund	Returns since inception of L Funds Aug 2005 – Dec 2012	Returns since inception of Automatic Enrollment Aug 2010 – Dec 2012
G Fund	28.06%	4.95%
L Income	35.40%	11.15%
L 2020	41.77%	21.14%
L 2020	43.13%	24.90%
L 2040	43.64%	27.70%

Since August 2005, cumulative returns of the L Funds ranged from 35.4% for L Income, the most conservative option, to 43.6% for L 2040, the most aggressive option (L2050 has only been available since the beginning of 2011). This compares to a return of 28% for the G Fund, over a similar period. While we should always remember that "past performance is not a guarantee of future results," it is apparent that a well diversified allocation outperformed the G Fund, albeit with a greater risk of loss than the G Fund, which is risk-free.

There will be periods when the G Fund will outperform one or more of the L Funds; however, over time, the L Funds should provide better investment performance to participants than a 100% investment in the G Fund, albeit with greater risk. In fact, figure 3 also illustrates that had the Lifecycle Funds been the default investment option since the start of auto-enroll, participants who remained invested during the entire period would have achieved greater investment returns and consequently, greater account balance growth (see figure 4) than offered by the default into the G Fund.

Figure 4

Growth of $100/month Cash Flow since Inception of Automatic Enrollment



AGENCY/SERVICE IMPACT

Changing the default fund will not require payroll or personnel offices to modify any of their existing procedures or systems. Therefore, we did not solicit feedback from the civilian agencies or uniformed services on this program change.

COST IMPACT TO FRTIB

FRTIB will need to make limited modifications to the TSP recordkeeping system in order to change the default fund. The most significant programming requirement is the calculation of the participant's draw-down date in order to default the participant to the L Fund with the appropriate time horizon. We estimate the cost for these system modifications to be $150,000 to $200,000.

As the change to an L Fund default will apply only to newly hired or rehired employees, a broad communication campaign to all participants is not required. Agency/uniformed services communication of this feature will occur as part of standard new employee orientations, which address all benefit programs. We estimate the cost for modifying the print materials and website to reflect the new default option to be in the range of $75,000 to $100,000.

Finally, we do not anticipate that a change to the default fund will have a material effect on staffing needs.

LEGISLATIVE CONSIDERATIONS

The TSP is governed by FERSA, not ERISA. Consequently, the PPAs QDIA authorization and the DOL's interpretive guidance do not authorize the TSP to establish the lifecycle funds as its default option nor would either authority protect the TSP's fiduciaries from liability should the lifecycle funds be established as the default option. In order to establish the lifecycle funds as the default option, Congress would need to amend FERSA (5 U.S.C. § 8438(c)(2)) to change the default option and Congress would also need to amend FERSA's acknowledgment of risk provision (5 U.S.C. § 8439(d)) and may further need to make amendments to 5 U.S.C. § 8477 (e) in addition to those made by the TSP Enhancement Act of 2009.

CONCLUSION

The L Funds, offer professionally managed allocations across the core asset classes available in the TSP and are designed to maximize expected performance for the amount of risk taken. Furthermore, the design of the L Funds automatically addresses changing asset allocation needs as participants near their draw-down dates. While there may be concern that we are exposing a participant's retirement savings to the risk inherent in the capital markets, we believe the L Funds appropriately address those risks in their design. Those participants who conclude that they do not want to assume such risk will be able to opt out of the default option. While the G Fund offers no risk of investment loss, the potential for investment returns with the G Fund is significantly lower, when compared to long-term equity market performance. The more diversified investment allocation afforded by the L Funds and consequent expected stronger performance will be another step towards helping participants more effectively save for their retirement.

Therefore, for long-term investors, which include the vast majority of newly-hired Federal employees and certainly younger participants, the L Fund is a more appropriate default option.

The TSP has been very successful attracting individuals into the Plan. However, implementing a default to the appropriate L Fund will represent a significant step forward in combating the negative impact of inertia – young and newly hired participants not actively managing their TSP accounts.