FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
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THRIFT SAVINGS PLAN

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MEMORANDUM FOR: BOARD MEMBERS KENNEDY, BILYEU, JONES, MCCRAY AND JASIEN

FROM: GREG LONG Executive Director

SUBJECT: Mutual Fund Window Option

Background: The Thrift Savings Plan (TSP) Enhancement Act of 2009 (P.L. 111-31, Div. B, Title I § 104) (Act) was signed into law on June 22, 2009. The law granted the Board the authority to establish a Mutual Fund Window (MFW) for TSP participants. In the same year, the Federal Retirement Thrift Investment Board's (FRTIB) Executive Director initiated discussions with the FRTIB Board Members (Board) and the Employee Thrift Advisory Council (ETAC) about the addition of a self-directed mutual fund option to the TSP investment lineup. In the April 2009 FRTIB meeting, the four Board members in attendance deadlocked on the decision to adopt a resolution in support of the MFW by a vote of two to two. ETAC members were similarly divided in their support for the MFW. Subsequent discussions led to a plan to reexamine the issue.

In order to reexamine the benefits of and concerns with a MFW, the FRTIB assembled a cross-functional team with representation from its operations, legal, investment, finance, communications, research, and technology offices. The team produced this study to provide insight into industry offerings, participant interest, costs, and operational considerations to assist the fiduciaries in determining whether adding a mutual fund window to the TSP is beneficial and prudent.

What is a Mutual Fund Window? During the past decade, many private sector 401(k) plans have added self-directed investment alternatives to their plans. These options have been in the form of either a full-service brokerage window or a scaled-down version generally referred to as a mutual fund window. The brokerage window typically allows participants to select investments from a list of publicly-traded securities and mutual funds. The MFW provides access to a broad range of mutual funds, but no individual stocks or bonds. Historically, these self-directed accounts have been most appealing to highly compensated participants and/or a few vocal participants who prefer access to a wider range of investment choices than are in the Plan's core investment options.

Typically, plans offering MFWs will charge participants accessing this option a monthly or quarterly fee. This fee is designed to cover the cost of setting-up/administering the feature and is assessed against the account balances of only those participants utilizing the MFW. In addition to this set-up/maintenance fee, the participant will bear the trading costs and other charges assessed by the MFW provider.

What Did We Learn? Through this process we have answered multiple critical questions about common industry practices, vendor capabilities, participant demand, operational concerns, and implementation process and costs. However, questions about the impetus behind rollovers out of the TSP and the extent to which a MFW can potentially change that behavior are still unanswered. Consequently, we remain in data-gathering mode to answer these questions. At this point, we can provide the FRTIB Board Members with arguments both for and against the MFW. When additional data points become available this fall, I will provide a recommendation to the FRTIB Board Members.

Best Practices

As the defined contribution (DC) industry continues to evolve, plans are moving away from investment menus that have a large line-up of funds. More plans are now pursuing a three-tiered approach, which recognizes the different levels of participant involvement and ability in managing investments. With this approach, "the plan identifies the participant profiles they are trying to serve in each tier of the investment menu. There are three typical profiles: Do It For Me, Do It With Me, and I'll Do It Myself. This 'choice architecture' allows a participant to easily identify with a profile and pick from a respective tier."[1] The TSP satisfies the "Do It For Me" profile with the professionally determined investment mixes in the Lifecycle (L) Fund options. The "Do It With Me" participants can use the five core investment options to pursue their investment strategy. By offering a limited set of options, the TSP "aids participants' allocation and decision-making."[2] Currently, the "I'll Do It Myself" participants are stymied by the lack of specialized and niche investment options in the TSP. Although the industry identifies these three tiers of participants, it also recognizes that a small minority of participants will fall into the third tier – I'll Do It Myself – as evidenced by the usage rates of mutual fund and brokerage windows.

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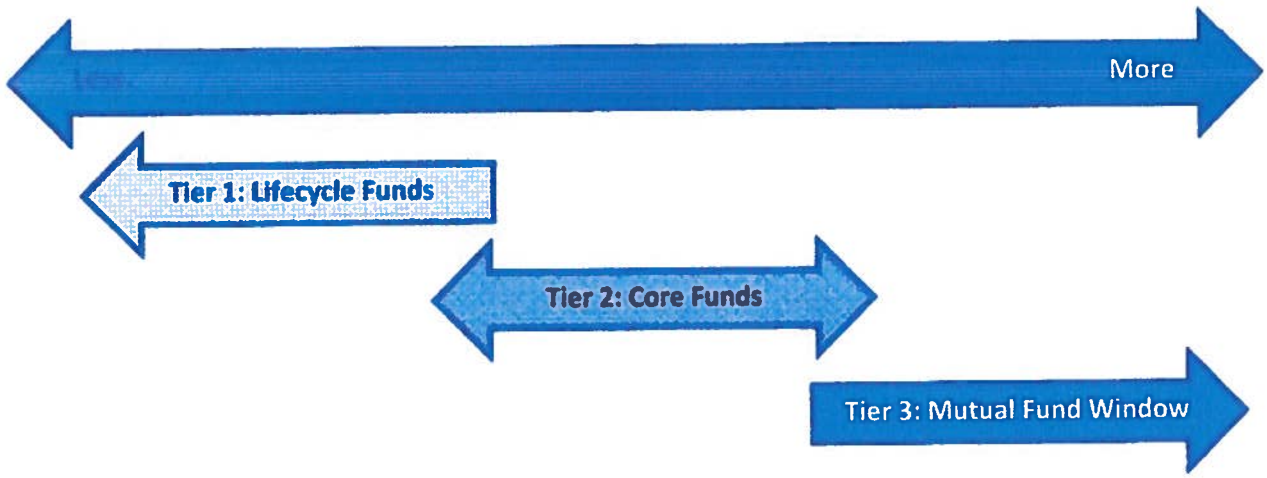
[1] "Seven Attributes of an Excellent Defined Contribution Plan," Russell Investments (February 2012) pg.2.

[2] "Seven Attributes of an Excellent Defined Contribution Plan," Russell Investments (February 2012) pg.2.Id.

Participant Involvement in Managing Investments



Availability and Usage

As noted in the table of DC surveys below, providing access to a self-directed brokerage account (SDBA) or a MFW in private sector 401(k) plans is becoming more prevalent. While the MFW provides considerable investment flexibility to DC plan participants, the percentage of participants actually utilizing this feature is quite small. Participant usage rates have been mostly static, even when plans reduced their associated fees or increased their marketing efforts.

National Defined Contribution Surveys	2008	2009	2010	2011	2012
Aon Hewitt Trends and Experience in 401(k) Plans (285 plans surveyed in 2009; 546 in 2011)					
▪ Plans offering SDBA	n/a	26%	n/a	29%	n/a
▪ % of assets in SDBA	n/a	3%	n/a	2%	n/a
Deloitte 401(k) Benchmarking Survey (436 plans surveyed in 2008; 523 in 2009; 449 in 2010; 332 in 2011; 303 in 2012)					
▪ Plans offering MFW	9%	9%	13%	11%	12%
▪ Plans offering SDBA	18%	18%	32%	27%	22%
National Association of Government Defined Contributions Administrators (NAGDCA) Survey (119 plans surveyed in 2008; 107 in 2009; 77 in 2010; 84 in 2012)					
▪ Plans offering SDBA	56.3%	50.5%	55.8%	n/a	57.1%
PlanSponsor DC Survey (5,973 plans surveyed in 2008; 5,929 plans in 2010; 6,885 in 2011; 6,184 in 2012)					
▪ Plans offering SDBA	15.2%	n/a	14.2%	17.9%	18.8%

Plan Sponsor Council of America (PSCA) Annual Survey					
(908 plans surveyed in 2008; 931 in 2009; 820 in 2010; 840 in 2011; 686 in 2012)					
▪ Plans offering MFW	8.3%	1.0%	6.1%	5.4%	5.6%
▪ Plans offering SDBA	15.5%	18.5%	20.8%	21.7%	17.1%
▪ % of total year-end fund balance in MFW	1.9%	0.2%	1.7%	0.3%	0.2%
▪ % of total year-end fund balance in SDBA	0.6%	0.9%	0.9%	1.2%	1.1%
▪ Average allocation in self-directed MFW	1.5%	0.2%	0.8%	0.6%	1.3%
▪ Average allocation in SDBA	2.2%	1.8%	2.6%	2.4%	2.4%
Vanguard How America Saves (2,200 plans surveyed in 2008; 2,200 in 2009; 2,200 in 2010; >2,000 in 2011; >2,000 in 2012)					
▪ Plans offering SDBA	11%	9%	10%	11%	12%
▪ % of participants using SDBA	n/a	1%	1%	1%	1%

Highlights from Plan Sponsor Interviews: To glean additional insight into the availability, usage, and administration of mutual fund windows, the TSP conducted several interviews with DC plan sponsors in the public and private sector as well as with one DC plan record-keeper. Consistent with what is reported in the national surveys, the plan sponsor interviews revealed that the availability of an SDBA or MFW option is limited. For plans that offer a MFW as a complement to their existing core group of funds, the usage rate is typically less than 1% of the total participant population within the plans. The conversation with the record-keeper made clear that plan sponsors frequently add a MFW option to address the vocal interest of those who want to add specific funds to their investment line-ups even though they know participant usage will be low.

When examining the structure of the multiple MFW offerings, there were variations among the plans the FRTIB surveyed. The minimum initial investment in the SDBA or MFW ranged from $500 to $5,000. There was also a range on the amount of assets that must be retained in the plans' core funds. For example, one plan required 50% of the account balance to remain in the core funds while another only required 10% of the account balance to remain in the core funds. In addition, the interviewed plans charged participants using the MFW a fee of $25 to $50 to cover recordkeeping and administration expenses. Supplemental research revealed that other plan sponsors charged fees as high as $100. These annual fees are in addition to any trading or transaction fees associated with specific funds in the respective MFW offerings.

While a growing number of plan sponsors offer a MFW/SDBA, they generally do not provide investment advice to support participants in making decisions within these options. Most relied on educational efforts and online investment tools. Only one of the interviewed plans offered one-on-one investment advice specific to the MFW/SDBA.

Input from Industry

To supplement the plan sponsor information, the TSP posted a Request for Information (RFI) in a leading industry publication. Four of the largest firms that administer SDBAs or MFWs for public and private sector DC plans responded to the RFI. As discussed below, the responses provided useful insights and were generally consistent with information obtained from other sources.

Investment Choices: The number of mutual funds offered by the respondents ranged from 6,000 to 23,000 funds. These mutual fund offerings come from over 670 mutual fund families. The funds include load-funds (with sales charges typically paid to retail brokers), no load funds, funds with no transaction fees (NTFs), and institutional funds not normally available to retail investors.

Fees: The fees differ depending on the fund selected; however a flat per transaction fee which ranges from $20 to $75 is common for no-load funds. NTF funds have zero transaction fees which makes them a popular option. With all funds, the participant will be paying the expense ratio of the fund as described in the prospectus.

Fund Access: All four respondents allow plan sponsors to select funds from their line-up of mutual fund offerings.

System Integration: All four respondents have experience integrating with the TSP's recordkeeping software. One respondent further noted its adoption of Single Sign On (SSO) technology, which allows participants to login to their plan accounts and automatically launch their MFW accounts without additional login credentials.

Participant Services: Three of the vendors reported that they could work with plan sponsors to customize any MFW communications. While the details of such materials varied by vendor, most said they typically developed an informational brochure, an enrollment application, and a "welcome kit" with additional details for those who wish to sign up. In short, their contact would be limited to account services and compliance with regulatory matters; all of the vendors reported that they did not send marketing materials directly to plan participants.

Input from Participants

National surveys and plan interviews both revealed that participant use of the MFW option is typically low, hovering around 1%. To gauge if the TSP would have similar usage rates, a survey was posted on the TSP website in December 2013. The survey received 6,250 views, and 4,239 respondents completed the survey. The key findings from the survey are below.

Percent of respondents that agree or strongly agree with the statement

36%	The TSP would be a better program if it provided a mutual fund window.
29%	I would transfer some of my TSP account balance to a mutual fund window.
22%	I would be willing to pay an annual fee in order to use a mutual fund window.

Those interested in a mutual fund window. . .

38%	Would be willing to pay an annual fee between $50 and $200 to use the MFW.
21%	Would invest less than 5% or less in the MFW.
9%	Would invest 50% or more in the MFW.

These responses are consistent with the feedback received in the *2008 TSP Participant Survey* in which 39% of respondents agreed that the addition of a mutual fund window would improve the Plan. It is also worth noting that 74% of the website survey respondents stated that they currently invest in stocks or mutual funds outside of the TSP. Lastly and consistent with overall market, interest in the MFW was strongest among respondents with account balances above $100,000.

Implementation Duration and Costs

While respondents to the RFI indicated that they could seamlessly integrate with the TSP recordkeeping system, this integration only relates to the transfer of assets between the TSP and the MFW provider. Internally, the addition of a MFW will impact a large number of key business processes (e.g., loans, withdrawals, etc.). The FRTIB team assessed the TSP's 100+ key business processes and identified approximately 50 processes that will require some amount of modification to accommodate the MFW. Modifying these business processes will require a large-scale project. The team provided a rough-order-of-magnitude (ROM) estimate indicating a project with estimated costs in the range of $6-$10 million and a duration of approximately 18 months. Once complete, we anticipate ongoing maintenance costs of about $1 million annually. A more definitive project plan, including timeline and cost estimates will be developed if the FRTIB receives Board authorization to proceed with the implementation of a MFW offering.

What Data Do We Still Need?

One question we are still trying to answer is: "To what extent would participants who currently leave the TSP shortly after separation from Federal employment choose to stay with the TSP if the TSP had a MFW?" We have several interesting data points that lead to a troubling hypothesis, but we are still searching for more conclusive data. What we know is:

- From TSP distribution data, we know that 45% of participants that separated from service in 2012 removed all TSP funds and closed their account by the end of 2013. In 2013, these separations caused nearly $10 billion to leave the TSP. Almost 72% of that amount was transferred to another financial institution or employer plan.
- The 2013 TSP participant survey data tells us:
    - That most actively employed participants do not plan to move their assets after they separate, but 36% indicated they would transfer assets post-separation in order to access more and/or better investment options.

This data leads to a hypothesis that a significant number of TSP participants are leaving the low-cost TSP to move to higher cost IRAs because they are swayed by the financial industry's marketing efforts which promote the benefits of a large menu of investment choices. Where participants are leaving the TSP after separation, we need to understand if this is driven by a desire to access greater investment choices, the need for investment advice, desire for additional withdrawal flexibility, or simply because participants thought they were required to close their account.

To determine if this hypothesis is true, we are:

- Designing a survey to reach participants that execute a post-separation full-withdrawal. We expect results by the Fall of 2014.
- Analyzing the demographics of the participants who executed a full withdrawal. This will help us understand where the money from separated accounts is going and how this behavior changes based on age and account balance.

Mutual Fund Window – How Might It Work in the TSP?

While no decision on creating a MFW in the TSP has yet been made, it is instructive to consider how we think it would actually work in the TSP. Below we articulate likely business rules around how this feature would work in practice.

Participant Maximum Allocation: Participants would not be permitted to transfer additional dollars to the MFW if it would cause their MFW balance to exceed 25% of their total TSP account balance. This limit is in recognition that the MFW will allow access to funds that are not as diversified as the TSP's core funds and therefore may expose the participant to greater market risk. While there may be legitimate reasons for a participant to invest in a particular market sector or country, such niche needs can be met through a limited portfolio allocation. Additionally, since these funds can expose a participant to greater risk, we seek to limit the potential harm that could occur if the participant does not exercise prudence. For example, an allocation to a fund that invests exclusively in Asian bio-technology companies may be a prudent choice for a small portion of a high-risk portfolio. However, it may be imprudent for us to allow a participant to invest 100% of their retirement assets in such a fund.

Minimum Initial Investment: Participants who elect to use the MFW would be required to make an initial investment of $5,000 or more. The MFW maximum allocation combined with the initial investment minimum will ensure that participants have accrued assets of at least $20,000 and therefore have significant experience in investing prior to accessing the MFW.

Fund Screening: Through a MFW we could offer virtually any fund available in the marketplace. However, we will likely limit the funds to those that are available at no-load (no sales charge) with or without a transaction fee. Also, we are considering an additional screen to limit the window to funds that have expense ratios below a certain threshold, such as 1.00% or less. The purpose of this is to limit the potential for participants to unknowingly enter into transactions that cost far more than expected. The TSP is the leader in low cost retirement investing and we are passionate about keeping costs low for participants. We would offer access to higher cost funds through the MFW because we recognize that a small portion of our participants have niche and specialized needs that cannot be met in the core TSP without adding counter-productive complexity for all participants. Screening would enable us to allow access to the funds while still limiting fees to reasonable levels.

Participant Fees: Our goals in structuring the pricing of the mutual fund window would be: 1) To ensure that the pricing adheres to the requirement in the TSP Enhancement Act that "any expenses charged for use of the mutual fund window are borne solely by the participants who use such window"; 2) that we provide fairness in allocating TSP operational expenses (specifically, the assets that move to the MFW would no longer have the TSP operational expense deducted from them, and we need a mechanism to resolve that inequity; and 3) that any fees not be significantly outside of normal pricing in the marketplace. To these ends, we foresee charging MFW users an annual fee of $50-$100 plus a basis point charge on assets that approximates the administrative charge applied to the core funds, or approximately .03%.

An open question is whether the annual fee should be used to only offset the annual on-going costs of administering the MFW of approximately $1 million or the annual maintenance cost plus the initial one-time project charges of approximately $6-$10 million. When launching or modifying a service that is available to all participants (but will only be used by some participants), it has been our practice to charge the implementation costs to all participants. For example, when we modified our loan program, the costs to modify the program were shared by all participants but only the participants who request a loan are charged the $50 fee. With the MFW, we are considering a different approach. In this case we may track the total actual costs of implementation and maintenance and use MFW fees to offset that full amount. At some point in the future, when implementation costs are covered, the annual account fee could be reduced. As a point of reference, if 1% of TSP participants opened a MFW account and paid a $100 fee, that would generate (45,000 X $100 = $4.5 million) revenue, sufficient to recoup the estimated implementation costs in about 2 years.

MFW Transfers: Participants who wish to invest in the MFW would be required to initiate a transfer to the MFW through a process similar to the current inter-fund transfer (IFT) process. Direct investment in the MFW via payroll deduction would not be permitted. Precluding investments by payroll deduction should help to ensure that investments in the MFW are the result of mindful, active investment decisions rather than investor inertia. Participants accessing the MFW would be required to complete a one-time Acknowledgment of Risk (AOR). Lastly, participants will need to understand that transfers to the MFW will require a multi-day process that allows for the liquidation of the transfer amount from the core funds before that amount can be invested inside of the window.

Loans and Withdrawals: Both loans and withdrawals will be issued from the core fund balance. As a result, the processing time for loans and withdrawals (only for participants that have a MFW balance) could be slowed in order to ensure that the loan or withdrawal request does not increase the MFW balance above the 25% maximum and, if it does, to allow time for the transfer of MFW assets back to the core funds to complete the request. This rule will prevent the need to liquidate small MFW amounts in order to make pro-rata distributions across the core funds and the MFW.

Other Distributions: There are a number of circumstances under which the TSP must take actions to remove money from accounts for reasons other than participant-initiated distributions. These include forfeitures, court orders, tax levies, required minimum distributions, returns of excess deferrals, and negative adjustments. If there were insufficient assets in the core funds to issue the distribution, the TSP would direct a forced liquidation and transfer. Participants would be notified in advance of such actions.

Account Access and Statement Reporting: The addition of a MFW would have implications for the "My Account" section of the TSP website and participant statements. Since any assets in the MFW are TSP assets, the "My Account" section of TSP.gov will need to show the current aggregate dollar amount of participants' MFW holdings. Similarly, annual and quarterly statements would have to be modified to report the aggregate MFW balance and display the annual MFW fee.

Board Considerations

The Thrift Savings Plan Enhancement Act of 2009 permits the Board to "authorize the addition of a mutual fund window...if the Board determines that such addition would be in the best interest of participants." In determining whether to authorize a MFW, the Board must fulfill its fiduciary duties of loyalty and prudence and consider how to ensure proper allocation of the costs of maintaining the window. These are important guidelines to keep top-of-mind when considering the supporting and opposing arguments in the following section.

Supporting Arguments

Some customers want more choices: The TSP is designed to offer an uncomplicated, broad-based lineup of investment options. An important feature of the core investment menu is that there are no overlapping securities or sectors among the funds. While this design serves the needs of many, it does not serve the needs of all. For those who want access to a precious metals fund, an emerging markets fund or a high-yield bond fund, the TSP has no option to meet their requests. Good organizations are responsive to the needs of their customers; we should be too.

Retain simplicity of core lineup: Some participants and other special interest groups have requested that the TSP investment line-up include additional funds. Legislation that would compel the TSP to expand its core offerings has been introduced multiple times over the years. These fund requests have been based on a variety of reasons including religious, social, and international political concerns. Others have requested niche funds ranging from precious metals to renewable energy. A MFW would allow the TSP to enhance its offerings for those individuals seeking further portfolio diversification or investments in sector specializations, while preserving the simplicity and low costs of the core funds for the vast majority of participants who will not use the MFW.

Continued participation in low cost TSP: FRTIB research has noted that roughly 45% of participants who leave Federal service have withdrawn their TSP accounts one year after separation.[3] Furthermore, the *2013 TSP Participant Survey* asked respondents why they would consider transferring their TSP account balance after separation and 36% of active participants stated they would transfer their accounts for more or better investment choices. Investment choice was the second highest transfer reason after account consolidation (42%).

In recent years, TSP participants have become an even more popular target for other programs. For example, one financial institution specifically notes on its website that TSP participants could benefit from access to "thousands of investment choices, including stocks, bonds, and no-load mutual funds" by rolling over to one of their IRAs. The company even describes the TSP forms necessary to request partial and full withdrawals. Because of these trends, the Agency has identified account retention as one of its priorities for the current year, and the MFW can be an important contribution to the account retention effort.

Furthermore, age-based withdrawals from the Plan – in which active participants age 59½ or older make a penalty-free withdrawal from their accounts – have increased by more than 50% since 2009. Perhaps more interestingly, the average dollar amount of those withdrawals has nearly doubled from $53,000 to almost $100,000. In 2013, 70% of the $1.8 billion in age-based withdrawals were transferred to other financial institutions. In other words, most participants are not making these withdrawals because they need immediate access to cash; they are sending the money directly to other retirement/investment vehicles.

Creating a MFW option could help retain participants who might otherwise be lured away by outside promises of greater investment flexibility. Providing such diversification would allow these participants to increase their overall investment options while continuing to enjoy the benefits of the Plan's considerably lower administrative expenses for their core investments.

Greater asset retention creates lower fees for all participants: To the extent that an MFW discourages participants from choosing to invest elsewhere, the money that might have otherwise left the Plan will help reduce per capita administrative costs even for participants who do not participate in the window.

The MFW would become a data source: Data on MFW usage will be a key input to future analysis of core fund menu reviews. Whenever the Board considers changes/additions to the core investment menu, participant demand is a key question. The MFW will be an excellent source of data in this respect.

Opposing Arguments

Why add complexity to only help the vocal minority? As noted in this report, typically only 1-2% of participants actually use a MFW (or SDBA) when offered. These usage rates have remained steady even in the case when a provider eliminated account fees for the MFW. Why would we spend up to $10 million to add a complicated service which introduces greater operational risk when less than 100,000 participants are likely to use it?

The law requires us to pursue low costs: The MFW may be detrimental to participants because the costs of the mutual funds available within the window are much higher than TSP funds. Although prices of individual mutual funds will vary, the average cost of a mutual fund in 2012, according to the Investment Company Institute, was between 61 and 77 net basis points (bps). This average is significantly more expensive than the average cost of the five TSP Funds, which cost a net average of 2.7 bps in 2012 and 2.9 bps in 2013. The higher costs of mutual funds could significantly impact the long-term retirement savings of TSP participants.

Some participants make bad choices and the MFW could amplify the harm of bad choices: The MFW may be detrimental to participants because some will pick high risk funds that may perform poorly. If they want to do this in accounts outside the TSP, it is not the FRTIB's business. Our job is to protect the interest of participants and allowing them access to some high-risk funds is enabling risky behavior.

Resolve gaps through the core funds: If the MFW allows people to close a real gap in their TSP portfolios, then we should close that same gap through our core fund menu. The FRTIB should close gaps in the same way it always has, through a methodical consideration of pros/cons of adding such a particular fund to the core.

Too much choice is paralyzing and fragments our educational message: The investment options available within the window could overwhelm participants. MFW providers stated that they offered between 6,000 and 23,000 mutual funds on their respective trading platforms. While the individual fund offerings in the MFW will not be part of the TSP core investment line-up, the MFW still fragments our communication message. Studies have consistently shown a correlation between the increasing number of investment options and participants' decreased ability to diversify their investments within a participant-directed account such as the TSP.

Closing Thoughts

The decision of whether to offer a MFW within the TSP is a major decision that falls to the Board members who are charged with deciding investment policy under FERSA. There are compelling arguments both for and against this change. It is also an issue over which smart and good-intentioned people can disagree. I ask that that the fiduciaries give this significant thought and that we reach out to our partners on the ETAC to get their input. Before the year is out I expect to provide you with a recommendation for action.