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

July 27, 2015

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

FROM: GREG LONG Executive Director

SUBJECT: Mutual Fund Window Option

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) in addition to the Plan's current investment offerings of five core funds and five Lifecycle funds.

Over the last two years, my team has conducted extensive research into the MFW option. In May 2014, the team's in-depth study provided insight into MFW industry offerings, participant interest in the option, preliminary cost estimates, and operational considerations. In November 2014, a second report highlighted the potential of a MFW to improve account retention as well as illustrated the meaningful impact on fund availability if the MFW screened based on costs. This final report provides a more thorough examination of the costs associated with implementing the option. Most importantly, this report summarizes the key benefits for adding a mutual fund window to the Plan. Thus, it is my hope that the combined information from these three reports allows the Board to reach a decision on the MFW.

BACKGROUND

In the first study, we noted that a review of defined contribution industry surveys revealed that MFW and brokerage window offerings have been on the upswing, with 12% to 29% of plans offering this option. However, the number of participants (1%) using these offerings and the amount of assets (1% - 3%) invested in them have remained consistently low over the past five years. These very low usage rates are in stark contrast to the reported interest of TSP participants. In the *2008 TSP Participant Survey,* 39% of respondents agreed that the addition of a mutual fund window would improve the Plan. That level of interest was reaffirmed when an online survey specific to the MFW was posted in December 2013, and participants responded as shown 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.

In addition to gauging participant interest, we also conducted a preliminary review of our business processes to assess the impact of a MFW. The MFW will have varying levels of impact on approximately 50 of our 100+ business processes. Based on this review, we provided a rough-order-of-magnitude (ROM)[1] estimate in the range of $6-$10 million to make the required systems modifications to implement a MFW.

In our second study, we focused on fund screening and account retention. To determine the viability of a process to screen-out expensive funds, we inquired with MFW platforms as well as plan sponsors about the use of screens and also examined the potential impact of placing a screen based on expense ratio. We learned that screening would severely limit the options available and present additional operational challenges. Thus, fund screening was not typically utilized with a plan's MFW or brokerage option.

In addition to examining the impact of a fund screen, we also considered the possible effect of a MFW on account retention. As noted in the second study, separated participants withdrew nearly $10 billion from the TSP, with almost 72% of that amount being transferred to another financial institution or employer plan. To better understand the drivers behind this activity, we surveyed 30,000 participants who took a post-separation withdrawal and 10,200 participants who made an in-service age-based withdrawal in the first half of 2014.

Our conclusions from the survey are that we have three plan design-related opportunities to improve account retention. We can improve retention through more flexible withdrawal options, through improved services related to investment guidance and advice, and through the creation

[1] A ROM or Rough Order of Magnitude is an estimate that will have an accuracy of about plus or minus 50%.

of greater investment flexibility. Focusing on the last plan design opportunity, the creation of a MFW would reduce concerns of limited investment flexibility expressed by 23% of those participants that executed post-separation and age-based in-service withdrawals. Although we cannot predict how much any plan design change would impact the rate of retention, it is important to highlight the realm of possibilities. For example, if a MFW were available in 2013 and it caused just 10% of distributed dollars to stay at the TSP, our net cash flow would have improved by $1.2 billion. In addition, the directly-affected participants would have paid substantially lower fees, and *all* TSP participants would have benefitted through marginally lower asset-based administrative fees.

While our research revealed the benefit of the MFW, we still needed to explore the fiduciary considerations with offering a window. FERSA protects the Plan fiduciaries from participant investment decisions by requiring an "acknowledgement of risk" from participants before allowing them to invest in any funds with the potential of loss. However, it should be noted that, up until the authorization of a mutual fund window, the types of funds offered by the TSP were established by statute. Thus, the fiduciaries had no discretion to select investment options that were not already approved by Congress, and accordingly their primary investment responsibilities were selecting the criteria for implementing the approved options and monitoring the management of the options. The Board, in accordance with section 8475, is required to "develop investment policies under section 8472(f)(1) of this title which provide for (1) prudent investments suitable for accumulating funds for payment of retirement income; and (2) low administrative costs."

The Thrift Savings Plan Enhancement Act, which allows the addition of a MFW, makes explicit the Board's responsibility to consider all terms and conditions of the MFW in light of their fiduciary obligations. The statute protects the fiduciaries from liability for the investment decisions made by participants in the window, and protects them from liability for "establishing restrictions applicable to participants' ability to invest through the mutual fund window." However, the Act did not amend section 8475. Thus, the Board still must ensure that all investment options, including those found in the MFW, are "prudent investments suitable for accumulating funds for payment of retirement income" and that they have "low administrative costs." From this research, we concluded that the Board must seek to balance participant desire for increased investments options and their fiduciary requirements as defined in statute.

I have provided this brief recap of the two previous reports as they provide the foundation for the refined cost estimate as well as my final recommendation.

IMPLEMENTATION COSTS

In our earlier report, we provided a preliminary estimate in the range of $6-$10 million to implement a MFW. Since the earlier report, we have spent considerable time identifying the key business rules that determine the degree of system modification that the MFW will require. In our initial report, we discussed the high level business rules related to a participant's use of the mutual fund window, e.g., the minimum initial investment, maximum MFW balance, etc. However, to further refine the estimate, we needed to delve further into how the MFW would interact with other benefit features, e.g. loans and withdrawals. We consulted with plan sponsors, record keepers, and MFW vendors to gain insight into how other plans integrated the MFW into their other plan offerings. Lastly, we developed business rules based on the objectives listed below. The objectives are listed in order of priority, but ultimately a balance of the objectives was sought among the rules.

1. Reduce likelihood of transaction error by limiting complexity
2. Make it easy for the participant to understand
3. Make sure it's fair
4. Require a new employee to get TSP core fund experience before opening their window
5. Make it flexible so a participant can execute any reasonable request
6. Keep costs low
7. Be similar to the rest of the world

With improved insight and the above objectives, we were able to refine the cost estimate for the following four key areas of implementation:

MFW Provider Integration: We learned through our market research that many of the MFW providers have extensive experience integrating with defined contribution recordkeeping systems, and specifically with systems using SunGard's OmniPlus software, the recordkeeping software used by the TSP. Based upon this expertise, the respondents to our Request for Information estimated that integration with their platforms would cost $125,000 or less.

TSP System and Financial Reporting Modifications: As noted previously, the interaction of the MFW on other plan features impacts the cost of implementation beyond the integration with MFW provider. The estimate for system and reporting modifications includes changes to recordkeeping, accounting, document management, and participant contact systems. In addition, changes to the website and the statement process are needed to support participant information on their aggregate MFW assets. Based on the number of systems requiring modification, FRTIB recordkeeping implementation costs are estimated at approximately $5.9 million.

Participant Communication and Training Updates: Education of participants about the pros and cons of the MFW would be an important element of implementation. In particular, we must provide clear and unambiguous information on the costs and potential risks associated with investing in the MFW. The estimated cost to update TSP print and electronic media is $365,000.

Other Operational and Administrative Changes: In addition to the key implementation elements listed previously, we have also identified additional administrative expenses related to project management, revision of regulations to support identified business rules, and the training of Board and contractor staff on the new option. These expenses are estimated at $315,000.

Implementation Cost Summary

Integration with the Mutual Fund Window Provider	$125,000
TSP System and Financial Reporting Modifications	$5,920,000
Participant Communication and Training Updates	$365,000
Other Operational and Administrative Changes	$315,000
Total	**$6,725,000**

The four areas of implementation are expected to run in parallel and expected to take approximately 15 months for completion. The start date of the implementation period will begin at some date after the award of a contract to a MFW provider through open competition. The start of the implementation period will be determined based on the priority of this project relative to others and the availability of resources to dedicate to this work.

Key Benefits

At the presentation of the first report, I walked through the pros and cons associated with a mutual fund window. Those pros and cons are recapped in the charts below.

Pros
Allows more choice
Protects the simplicity of the core lineup
Encourages asset retention
May lower fees for all participants, as more assets are retained in the Plan
Provides fund usage data for future core menu reviews
Cons
Adds Plan complexity to help a vocal minority
Introduces higher cost investment options
Increases the risk of poor investment decisions
May overwhelm participants with investment choice

As you consider your decision on the mutual fund window option, I would like to focus your attention on two key benefits of the MFW – account retention and protection of the core menu.

Account Retention: Separated participants now make up 26% of our total plan participants. In 2005, only 16% of our participants were separated from Federal service. This shift is a reflection of both a maturing Plan as well as the aging demographic of the Federal workforce. However, as the dynamic continues, we must recognize that a sizable percentage of TSP participants can leave the Plan at any moment. Their exit from the plan may have negative consequences for the departing participants as well as the participants who remain in the Plan with potentially increased expenses for both sets of participants.

While other vehicles may provide participants with the greater withdrawal and investment flexibility that they noted in the survey, few if any can compete with the low costs of the TSP. While we can and have communicated that benefit, the message is often lost among the more attractive message of flexibility. Thus, many participants are unaware how the return that they are chasing is chipped away by higher fees. By adding the mutual fund window, we will provide participants with the investment flexibility that they want and that have been told that they need. It may seem counterintuitive to offer potentially more expensive options while touting the low cost of the current fund options. However, it is our position that while the MFW will satisfy participant desire for particular investment diversity, the bulk of participant assets will remain in the low cost core. With improved retention of separated participants, we reduce the expenses for all participants.

Protect the Core: One of the TSP's strongest selling points is that it offers 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. This plan design feature helps protect participants from investment redundancy and unintentional risk exposures. In addition, this simplicity is frequently highlighted in TSP publications, and the TSP has developed a reputation for being a straightforward plan with clear choices.

However, there are some participants and other special interest groups who have requested that the investment line-up include additional funds. Legislation that would compel the TSP to expand its core offerings has even been introduced over the years. For example, legislation has been introduced proposing new TSP funds based on mortgage-backed securities, socially responsible investments, Real Estate Investment Trusts, or precious metals. These proposed changes and other fund requests have been based on a variety of reasons including religious, social, and international political concerns. A mutual fund window would allow the TSP to enhance its offerings for those individuals seeking further portfolio diversification or investments in sector specializations, while preserving the simplicity of the core funds for those who choose not to use the MFW.

In the past, we have successfully maintained the simplicity of the core menu. However, that is no guarantee of future success. As the clamor of the voices swell, it will be increasingly difficult to defend the core fund menu. The addition of the mutual fund window responds to those voices. Further, we can design the presentation of the MFW in a manner that distinguishes it from the core menu and highlights its intended use by more experienced investors. With additional funds in the core, we have far more difficulty protecting participants from a naïve diversification strategy, in which they randomly invest in all funds on the menu. Currently, we have nearly 3% of participants who are pursuing such strategies with investments in all five core funds and one or more of the Lifecycle funds. Thus with the MFW, we answer the demand for expanded investment options while limiting the opportunity for poor investment decisions among a wider pool of participants.

RECOMMENDATION

A mutual fund window offers participants the opportunity to fine-tune their asset-allocation strategies. While we note the concerns with the MFW, such as introducing higher cost investment options and increasing the risk of poor investment decisions, I believe that we can mitigate some of these concerns through participant communication and effective structuring of the option. More importantly, we believe the benefits of the account retention and protection of the core fund menu far outweigh the concerns and provides a benefit to all TSP participants, regardless of their use of the MFW. Thus, it is my recommendation that a mutual fund window should be added to the TSP. With my recommendation, I would like to close with a quote from a plan sponsor who made the same decision.

> *We noticed an increase in rollouts and conducted a survey of participants to look for reasons/solutions. Participants expressed a desire for broader investment choices in line with the recommendations of their personal financial advisors. We implemented the . . . Window to meet that need. So far a tiny-tiny-tiny fraction of assets are in the window, but it represents freedom of choice to the participants.*