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CORRESPONDENCE MEMORANDUM

DATE: September 29, 2004

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Lifecycle Fund Recommendation

The Wisconsin Deferred Compensation (WDC) Board Investment Committee discussed the merits of lifecycle and lifestyle funds at their August 19, 2004, meeting. Based on that meeting, the Investment Committee is recommending that the WDC Board add a series of lifecycle funds to the WDC Investment Spectrum.

<u>Background</u>
As used by mutual fund firms, the term "lifecycle" describes the process of developing a diversified investment portfolio by strategically combining different asset classes in varying proportions according to an individual participant's age or time horizon. Lifecycle funds are increasingly popular and appeal most often to participants who do not have the time, knowledge or interest to regularly monitor and adjust their investment portfolio allocations. These participants struggle to make the right investment choice, worry about the choices they make, and often forget to rethink and rebalance their investments on a periodic basis.

Lifecycle funds are increasingly popular and offer benefits for sponsoring plans as well as participants. Lifecycle funds:

- Appear to be the easiest options for participants to understand and enroll in.
- Address plan sponsor or provider concerns regarding offering investment advice.
- Use modern portfolio theory regarding risk and return.
- Provide an asset mix developed by a mutual fund family (not the WDC or participant).
- Are kept on target with systematic rebalancing by the mutual fund family.
- Appeal to participants with low investment knowledge or compensation levels.

Lifecycle funds are offered by many of the major mutual fund families, including Vanguard, Fidelity, T. Rowe Price, Schwab, Barclays Global Investors, and Dimensional Fund Advisors.

At the Board's request, staff also reviewed the existing WDC asset allocation service and examined how lifecycle funds would fit with it and the objectives of the WDC.

<u>WDC Asset Allocation Service</u>
The WDC's customized asset allocation service was added in 1998. It allows participants to potentially maximize return and realize investment objectives while reducing total investment risk to the participant's investment portfolio through diversification.

Reviewed and approved by Pam Henning, Office of Strategic Services

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Signature Date

Based on the number of participants that indicated a need for a simple approach to investments, staff anticipated that the WDC asset allocation service would be extremely popular. Original estimates for use ranged from 20% to 40% of WDC participants. As of June 30, 2004, just over 20% of WDC participants are utilizing the service. The table below provides data on WDC participant use of the asset allocation service since inception:

WDC Asset Allocation Service

Year	# Starting Asset Allocation	Total # w/ Asset Allocation	WDC Population	WDC Population w/ Asset Allocation
1998	1,319	1,319	31,603	4.2%
1999	1,858	3,098	33,395	9.3%
2000	2,224	5,141	35,827	14.3%
2001	1,610	6,490	37,809	17.2%
2002	1,509	7,606	39,164	19.4%
2003	956	8,054	40,593	19.8%
2004	555*	8,446*	41,595*	20.3%*

* as of 6/30/04

Overall, it appears that the WDC participant population base has not embraced use of the asset allocation service as quickly as initially anticipated.

The table below provides a breakdown of WDC asset allocation service use by age, as of December 31, 2003. As the table shows, the greatest use of the asset allocation service is by younger participants. As of December 31, 2003, approximately 41% of participants ages 26 to 35 and 26% of participants ages 36 to 45 were enrolled in the asset allocation service. It seems that younger WDC participants are getting the message that asset allocation is a good idea and acting on that information to enroll.

WDC Asset Allocation Service by Age
(as of 12/31/03)

AGE	# using Service	Total in Age Bracket	% of Age Bracket Using Service
25 and under	868	1,446	60.0
26-35	2,857	6,918	41.3
36-45	2,756	10,745	25.6
46-55	2,340	13,870	16.9
56-65	613	5,965	10.3
66 and older	42	1,424	2.9

Based on information from the WDC staff, however, participants have some problems using the asset allocation service effectively, including difficulty in developing their personal asset allocation model. Some participants begin using the service and forget; they don't remember they elected and call regularly to find out why a change occurred in their accounts. Difficulties experienced with the WDC's asset allocation mirror examples found in a recent literature search, which also include the problem of participants failing to adjust their allocations as they age or change their risk tolerance. Other problems include situations where participants understand the need to maintain a diversified portfolio and how the asset allocation service can accomplish this, but they still are uncertain which investment options to use.

Asset Allocation Service Changes

Year	Asset allocation participant total	Asset allocation participants making changes
1999	3,098	200 (6.4%)
2000	5,141	508 (9.9%)
2001	6,490	598 (9.2%)
2002	7,606	737 (9.7%)
2003	8,054	759 (9.4%)
2004*	8,446*	1,238 (14.6%)

* as of June 30, 2004

WDC Objectives and Participants

The stated objective of the WDC is to be a supplemental retirement savings program for public employees that provides participants with the ability to invest pre-tax income in a broad range of investment alternatives.

WDC participants are a diverse group. The 2002 Cortex survey revealed that WDC participants can be categorized into three groups based on their knowledge of investment concepts: a group of high knowledge, high interest participants (24%); a group of average participants (53%), both in knowledge and in interest; and a group of participants (23%) that indicated that they had either slightly poor or extremely poor investment knowledge. This last group is just as interested as the other groups in making deferrals but lacks the investment knowledge regarding where to put their funds.

Regardless of their investment knowledge, WDC participants rely on the Board to provide them with solid investment options. While the WDC has done a good job of meeting the needs of the high knowledge, high interest group through the addition of the Schwab Personal Choice Retirement Account option and the core options provide many good investment alternatives for the average WDC participant, there does not seem to be a similar level of service for lower knowledge and interest participants. These participants would likely benefit from the inclusion of lifecycle funds in the WDC.

Recommendation

The Investment Committee recommends that the Board consider adding lifecycle funds to the WDC for use in conjunction with the existing asset allocation service.

Adding lifecycle funds could provide a benefit to certain segments of the WDC participant population. Lifecycle funds require the least engagement and fewest decisions by participants and less investment knowledge and education. Results from the 2004 WDC participant survey show that a majority of respondents (nearly 70%) said they would be very or somewhat interested in this type of fund.

Department staff believes there is merit in retaining the existing asset allocation service. This service is risk-based; participants analyze their risk tolerance, then allocate their WDC assets based on that knowledge. However, if this service is to continue, staff should also work with Nationwide Retirement Solutions (NRS) to develop and distribute additional educational materials that help increase participants' knowledge and understanding of the WDC's asset allocation service.

Next Steps
If the WDC Board agrees with the recommendation to add lifecycle funds to the WDC, staff will work with NRS to review lifecycle fund options for presentation to the Investment Committee and Board in 2005.

In addition to lifecycle fund fees, the Investment Committee will consider the following points as they review potential lifecycle funds for addition to the WDC:

- Mutual fund family reputation. Many lifecycle funds are "fund of funds" and invest in underlying funds offered by the mutual fund family. Thus, a lifecycle fund series will only be as good as the fund family operating the fund.
- Asset style. Fund families generally favor what they do best. A Vanguard lifecycle fund is likely to include index funds, for example, and similarly, Fidelity lifecycle funds would likely include large cap funds.
- Asset allocation mix. Different fund families have different opinions on the "best" asset mix for lifecycle funds. Some may have a higher ratio of stocks to fixed income investments, for example than others.

As noted in a previous memo to the Board on this topic, the Board would also need to make the following changes if lifecycle funds are added:

1. Amend the WDC Investment Policy statement to add lifecycle funds as an investment category within the core spectrum.

2. Revise WDC investment option selection and monitoring criteria to provide for either a waiver or the development of a customized benchmark (such as a benchmark established by the proportional allocations of the benchmarks of the underlying asset classes, if possible).

Staff will work on these revisions for presentation to the Board. The Board would be asked to approve these changes at the same meeting in 2005 that specific lifecycle fund recommendations are presented.