WISCONSIN DEPARTMENT OF EMPLOYEE TRUST FUNDS

STATE OF WISCONSIN
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
http://etf.wi.gov

CORRESPONDENCE / MEMORANDUM

DATE: January 20, 2015

TO: Deferred Compensation Board Investment Committee

FROM: Shelly Schueller
Deferred Compensation Director

SUBJECT: Vanguard Target Date Funds – Collective Trust Option

The Investment Committee is asked to consider changing the Vanguard Target Date fund offerings from retail mutual funds to lower-cost collective trusts.

Wisconsin Deferred Compensation Program (WDC) investment options fees and expenses were discussed throughout 2014 at Board meetings. The Board requested staff obtain confirmation from the WDC's investment providers that the WDC is offering its option at the lowest possible cost. Vanguard recently informed staff that the WDC might be eligible to convert its existing Vanguard Target Retirement Date Funds to collective trusts, which would be lower cost.

Since June 2007, Vanguard has offered lower- cost commingled or "collective investment trust" versions of the target date funds to select institutional investors who meet the requirements of section 401(a) of the IRC and certain government retirement plans described in s. 818(a)(6) of the IRC. As a s. 457(b) governmental plan, the WDC is a qualified governmental plan and could offer the collective trusts to participants. Additionally, Vanguard reserves the right to offer the collective trusts only to clients who meet certain asset minimum amounts.

Vanguard's Target Date collective trusts offer the identical investment approach as the Vanguard Target Date funds (including glide path and target allocation). The appeal of changing to collective trusts is that they are lower in cost than mutual funds. The Vanguard Target Retirement Date Funds offered through the WDC have expense ratios ranging from 16 to 18 bps (basis points). If the WDC's Target Retirement Date funds were converted to collective trusts, the expense ratios would drop to 8.25 bps.

Reviewed and approved by Matt Stohr, Administrator,
Division of Retirement Services
Matt Stohr
Electronically Signed 2/4/15

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Like mutual funds, commingled or collective trusts have specific investment objectives, may purchase stocks and bonds, etc., and are offered through investment managers. Collective trusts are pooled investment vehicles that are created and maintained by a bank or a trust company (in this case, the Vanguard Fiduciary Trust Company or VFTC) that holds ultimate responsibility for the investments. Collective trusts are subject to federal regulations via the Internal Revenue Service and Department of Labor, but not federal securities laws. The underlying mutual funds in the trusts are registered investment companies subject to the same regulatory oversight as other mutual funds. Per Vanguard, its Target Retirement Trusts are "structured as 'master-feeder' trusts. Each 5 year mandate (2015, 2020, 2025, etc.) has a master trust that actually invests in and holds Vanguard mutual fund shares. Clients [like the WDC] invest in shares of the feeder trusts (sometimes referred to as 'sleeves' or 'sleeve trusts') that in turn invest in units of the master trust."

As stated previously, the primary appeal of collective trusts for the WDC is that they have lower expense ratios than mutual funds. However, there are a few potential drawbacks for collective trusts:

1) Collective trusts do not have to produce a prospectus nor do they have to comply with federal Securities and Exchange Commission regulations. However, collective trusts are subject to their anti-fraud provisions, as well as banking laws, the Internal Revenue Code, ERISA and Department of Labor regulations. Annual audited financial reports are available to plan sponsors.
2) Collective trusts do not trade publicly, therefore transparency is lost. Investors cannot simply look up a trust via a ticker symbol. Note: Vanguard has stated that information on the performance of its collective trusts is available on the Vanguard website and can be made available directly to the WDC's record keeper and other interested parties.
3) Collective trusts are only required to provide an annual net asset value (NAV), whereas mutual funds report daily NAVs. Note: Vanguard has stated that it will include a daily NAV for its commingled trusts on the Vanguard website and will make them available directly to the WDC's record keeper and other interested parties.
4) Collective trusts aren't required to distribute dividends and realized capital gains. Rather, the value of these distributions are retained and reflected as in increase in share price. This is in contrast to mutual funds, where any capital gains must be distributed and in most cases are reinvested in the form of additional shares.

<u>Staff Recommendation</u>
Staff believes it would be prudent for the Investment Committee to recommend changing the Vanguard Target Date offerings to collective trusts. Although moving to collective trusts would eliminate some transparency currently provided by offering the retail mutual fund versions of the Target Date funds, this change would be consistent

with the Board's policies regarding offering low-cost options and would result in potentially better returns for participants investing in the Vanguard Target Date options.

Staff from Vanguard and the Department will be available at the February 2015 Investment Committee meeting to discuss the contents of this memo.

Attachment: 2014 Vanguard comparison of target retirement funds vs. target retirement trusts

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A comparison: Vanguard Target Retirement Funds and Vanguard Target Retirement Trusts

	Vanguard Target Retirement Funds	Vanguard Target Retirement Trusts
Investment approach	A fund-of-funds approach, investing in several underlying Vanguard mutual funds, gradually changing to a more conservative asset allocation as the Target Retirement Fund approaches its target year. (Vanguard Target Retirement Income Fund is an exception, with a static allocation.)	Identical investment approach, with the same glide path and target allocation.
Underlying funds	Investor Shares of five Vanguard index mutual funds.	The lower-cost Institutional or Institutional Plus Shares of the same Vanguard mutual funds.
Costs	16 to 18 basis points, including all fees and costs.	Contact your Vanguard representative to discuss pricing, which is often less than mutual funds for plans that qualify.
Legal structure	Mutual fund.	Collective trust, also known as commingled trust or group trust.
Eligible investors	Individual investors and retirement plan participants.	Restricted to qualified plans under Section 401(a) of the Internal Revenue Code and certain government retirement plans described in Section 818(a)(6) of the Code.
Regulatory oversight	Subject to all the applicable regulations for mutual funds, including federal securities laws such as the Investment Company Act of 1940.	Collective trusts are generally not subject to federal securities laws, but are subject to their antifraud provisions, as well as banking laws, the Internal Revenue Code, ERISA, and other Department of Labor regulations. **Note:** The trusts' underlying investments are mutual funds and are subject to the same regulatory oversight as other mutual funds.

(continued on reverse)

Note: There may be other material differences between products that should be considered.

	Vanguard Target Retirement Funds	Vanguard Target Retirement Trusts
Reporting requirements	Prospectus, statement of additional information, and annual and semiannual reports, among other reporting requirements. Daily net asset value (NAV) is available through Vanguard and through third parties such as the media.	Annual audited financial reports are available to plan sponsors. The trusts' NAVs only need to be reported annually, but Vanguard chooses to provide daily NAVs, as well as fact sheets and quarterly investment commentaries, which are all available anytime through Vanguard's website. (Trusts do not have ticker symbols and their NAVs are not available through the usual media.) **Note:** The underlying funds have the same reporting requirements as other mutual funds.
Dividend payments	Because of their mutual fund tax structure, any dividends and net realized capital gains are required to be distributed. However, in order to maintain tax deferral advantages, distributions are generally kept within the plan, often automatically reinvested in the funds. A reinvestment within the funds causes the value of these distributions to appear in the form of additional fund shares.	Tax-exempt collective trusts aren't required to distribute any dividends and realized capital gains. The value of these distributions are retained and reflected in an increase to the share price.

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For more information about Vanguard funds, visit institutional.vanguard.com or call 800-523-1036 to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

All investing is subject to risks, including the possible loss of the money you invest.

Investments in Target Retirement Funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in Target Retirement Funds is not guaranteed at any time, including on or after the target date.

The Target Retirement Trusts are not mutual funds. They are collective investment trusts managed by Vanguard Fiduciary Trust Company, a Pennsylvania trust company and a wholly owned subsidiary of The Vanguard Group, Inc.

For institutional and qualified investors only. Not for distribution to retail investors.

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P.O. Box 2900
Valley Forge, PA 19482-2900

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