Defined Contribution Trends and Alternative Investment Strategies to Improve Returns and Lower Risk

July 18, 2013
Think Tank Webinar Series  www.aon.com/ah_thinktank

July 18  Defined Contribution Trends and Alternative Investment Strategies to Improve Returns and Lower Risk
August 15  Retirement Trends
September 19  HR Technology Best Practices
October 17  Compensation Trends and Planning
October 24  Communication Trends in Retirement
November 21  Global Benefits Hot Topics
December 19  HR Effectiveness, Talent and Leadership
Today’s Speakers

Jamey Sharpe  Managing Director of Retirement Services, Chief Investment Executive, BlueCross BlueShield Association
Alison Borland  Retirement Solutions & Strategies Leader, Aon Hewitt
Suzanne Bernard  Client Practice Leader, Hewitt EnnisKnupp
James Fox  Account Executive, Aon Hewitt
Aon Hewitt surveyed 428 employers, representing 11 million employees, to examine current and future retirement benefit strategy.
<table>
<thead>
<tr>
<th>Financial Needs</th>
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<tr>
<td><strong>Millenials</strong></td>
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<tr>
<td>▪ Saving for…</td>
</tr>
<tr>
<td>– A home</td>
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<tr>
<td>– Paying down debt</td>
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<tr>
<td>– Credit issues</td>
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<td>– Insurance needs</td>
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<tr>
<td>– Medical options and cost</td>
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- Saving for…
- A home
- Paying down debt
- Financial decisions

- Saving for…
- A home
- College
- Retirement
- Financial help
- A plan for the future
- Insurance needs

- Saving for…
- Retirement
- Starting a business
- Retirement planning
- Timing
- Lifetime income
- Tax and Estate planning

- Saving for…
- Starting a business
- Tax-efficient retirement income
- Estate planning
- Medical options and cost
Path to Transformation

Spouse

Participant

Family

Other Long-term Savings

Go Broader

Retirement Savings

Go Deeper

Debt and Credit

Health Impact on Retirement Income

Lifetime Income

Financial Literacy

ENABLERS: Research | Technology | Help | Access to Data

Proprietary & Confidential | Think Tank Webinar
Types of Investment Advisory Services

- **One-on-one financial counseling:**
  - 2011: 44%
  - 2009: 29%
  - 2007: 22%

- **Online advice:**
  - 2011: 37%
  - 2009: 32%
  - 2007: 20%

- **Online guidance:**
  - 2011: 47%
  - 2009: 28%
  - 2007: 18%

- **Managed accounts:**
  - 2011: 29%
  - 2009: 26%
  - 2007: 11%
Retirement Income Solutions in PlanSupported

Managed Payout
- Steady payments
- No insurance

Single Insurer
- Single fund
- Near retirees

Multiple Insurers
- Multiple funds

Clients

Client

Clients
Two Potential Paths to Success

Investment Scrutiny Creating Two Paths

Delegate
- Select and monitor the Expert
- Rely on Expert for investment decisions and execution of strategy
- Reduce time, resources
- Improve participant outcomes

Empower Me
- Is personally responsible for investment decisions
- Get trained and partner with expert resources
- Ensure active and engaged Committee
- Maintain complex choice investment menu and facilitate education strategy
- Improve participant outcomes

Leverage Institutional Scale
Best-in-Class Providers
Manage and Reduce Risk
Leveraging Scale of DC Plans Through Institutionalization

Utilization by Vehicle Type

Entire 401(k) Market
- 12% Retail Funds
- 17% Collective Trusts
- 71% Separate Accounts

Aon Hewitt’s Clients
- 20% Retail Funds
- 47% Collective Trusts
- 33% Separate Accounts

Value of Scale Institutionalization

Reducing investment fees by **25 basis points** has the same value as...

...increasing the company contribution **0.5% of pay** for over an employee’s career
Barriers to Utilizing Institutional Vehicles

- 55%: Have not considered using institutional funds
- 32%: Prefer mutual funds
- 20%: Savings is not compelling enough
- 11%: Plan is not large enough
- 8%: Participants have requested mutual funds
- 5%: Do not have the flexibility with our current administrator

Source: Aon Hewitt 2011 Trends and Experience in Defined Contribution Survey
Mobile Trends

- Over 200 Clients on mobile site
- 4,615,779 mobile visits in 2012
- More than 190 different devices
Help People…Improve Their Financial Future

Create the Foundation

1. Analyze the workforce
2. Define tools and resources
3. Create a brand/theme

Motivate Action

1. Use multiple channels
2. Promote what you have
3. Target specific actions
Push to Encourage Action

People may need a “nudge” to help them take action.

1. Inertia
   Bias for status quo

2. Temporal Discounting
   Present vs. Future

3. Choices
   Liberation or Paralysis?

4. Loss Aversion
   Losing hurts worse than winning feels good

5. Social Norms
   What is everyone else doing?
The Role of Alternatives: Go Big or Go Home
How Investment Committees Spend Time

- Clients spend significant resources overseeing active managers, while contribution to risk is low
- Efficiency argument suggests active management believers should use more of it

Source: Vanguard Investment Counseling & Research
Active Manager Value Added and Active Risk

When fully adjusting for manager style and risk, we find value added only among the managers who take the most significant active bets.
A Solution

- We recommend that investors consider one of two directions with their investments:
  - An ‘Efficiency’ equity portfolio
  - An ‘Opportunity’ portfolio

- We believe that the Efficiency model is optimal for many investors.

- For others, consider a strategy that combines indexing with high-conviction active strategies. Alternatives play a significant role in this type of a portfolio.
Alternatives Have Become Mainstream

Investable Alternatives Market Size

- **Private Equity**: $3.2 trillion
- **Hedge Funds**: $2.3 trillion
- **Real Estate (U.S.)**: $7.0 trillion

Source: Prequin, Hedge Fund Research, Prudential Real Estate Investors
The Case for Alternatives

- Portfolio growth through *high expected returns*
- **Efficiency** improvement through strong risk-adjusted returns
- *Diversification and risk reduction* without return drag
- Part of a complete set of *market exposures*
  - Across spectrum of ownership and maturity
  - Beyond economic growth, inflation and interest rates
  - Into “exotic market exposures” not available in traditional stock and bond investments
Evidence on Alternatives Performance

Evidence that *average* alternatives manager outperforms
- Buyout managers outperformed over long term on average* 
- Private equity outperformed public equity** 
- Statistically significant outperformance in hedge funds***

Evidence of performance persistence
- In alternatives, significant evidence that strong past performers continue to excel, in:
  - Consecutive private equity funds raised by same firm
  - Strong-performing hedge funds
  - Consecutive real estate funds

* Harris, Jenkinson and Kaplan [2012]  
** Robinson and Sensoy [2011]  
*** Ibbotson, Chen and Zhu [2011]
Drivers of Alternatives Outperformance

Tailwinds…

- **Management discretion**
  - Lockups, notice and redemption periods

- **Compensation structure**
  - Avenue to maximize wealth for most skilled
  - Incentive structure

- **Investment strategy**
  - Flexibility and breadth
Focus resources where the impact is greatest… and find the best managers

Spread Between Top and Bottom Quartile Performance, 10 Years

Source: eVestment Alliance, Thomson Reuters, NCREIF, The Townsend Group, HFR
Acting on High Conviction

Contribution to Risk at Varying Levels of Alternatives Allocations

- **Clients should consider a risk budget allocation to alternatives that materially diversifies their reliance on equity**

  * Diversifying Assets are high yield, bank loans, emerging market debt, core real estate, commodities
Alternatives When Time Horizon is Shorter

- Shorter time horizons suggest an emphasis on liquidity
  - Greater use of “liquid alternatives”-- hedge funds and related strategies
  - Core open-ended real estate and REITs
  - Careful matching of plan time horizon with duration of cash flows from any less-liquid private equity and real estate investments
BCBS National Employee Benefits Administration

Provide...

→ *cost effective*
→ employee benefits programs & services
→ to member companies

RETIREMENT PLANS:

- Apply best practices in investment design
- Identify investments for optimizing return & risk
- Maintain top-level investment management
- Investments structured for success
BlueCross BlueShield

- BlueCross and BlueShield Association (BCBS) is a national federation of 38 independent BlueCross® and BlueShield® companies.

- BCBS’s National Employee Benefits Administration (NEBA) department offers cost-effective employee benefits services to Blue companies.

- NEBA manages $8 billion in retirement plans:
  - DB pension: National Retirement Trust,
  - DC: National 401(k) Program, and
  - Voluntary employee beneficiary association (VEBA) plans.

- BCBS partners with Hewitt EnnisKnupp (HEK) as its investment consultant and Aon Hewitt as its actuary.
BCBS National Retirement Trust

Pension Plan Structure

Equity

$2.0B

50%

- MSCI EAFE Index (passive)
- Emerging Market (active)
- Small Cap Int’l (active)
- Core (active & passive)
- High Yield (active)
- Portable Alpha–S&P 500 (active+passive overlay)
- Russell 1000 Index (passive)
- Russell 2000 Index (passive)

Fixed Income

$1.6B

40%

- Core (active & passive)
- Long Duration (active)
- High Yield (active)

Alternatives

$0.4B

10%

- Real Estate (¾ core private + ¼ global REITs)
- Managed Futures
- More?

Cash

0%

0%

$4.0 B

100%

$2.0 B

$1.6 B

$0.4 B

50%

40%

10%

20%

20%

15%

5%

6%

4%
Why an Alternative Allocation?

- Reduce risk: *Diversify* with additional sources of investment return
- Potential for *return* enhancement
- Portfolio *efficiency* via improved risk-return ratio of the overall plan

**Others Reasons**

- Take advantage of time-sensitive *opportunities*
- Added *protection* against interest rate risk, down-side risk
- Better pension *asset-liability* alignment
Current Alternative-type Investments

- **Portable Alpha**
  - The “beta”: S&P 500 stock return (passive exposure via futures)
  - The “alpha engine”: volatility trading; multi-strat; absolute return
  → Managers: Allianz, Wellington, and PIMCO

- **Managed Futures**
  - Quantitative and discretionary strategies
  → Manager: Graham Capital

- **Real Estate**
  - Private real estate: core and value added
  - Global public REIT
  → Managers: UBS, Prudential, and European Investors

- **Alternative Fixed Income**
  - Absolute return
  - Unconstrained bonds
  - Long duration bonds with equity beta
  → Manager: PIMCO
  - 14
## Historical Performance*

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 Year</th>
<th>3 Years</th>
<th>Year of Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity Portable Alpha</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allianz</td>
<td>20.4%</td>
<td>--</td>
<td>2011</td>
</tr>
<tr>
<td>Gottex Fund</td>
<td>17.4</td>
<td>13.9%</td>
<td>2008</td>
</tr>
<tr>
<td>PIMCO- Absolute Return</td>
<td>21.1</td>
<td>18.5</td>
<td>**</td>
</tr>
<tr>
<td>Wellington- Multi Strat</td>
<td>14.7</td>
<td>12.9</td>
<td>2008</td>
</tr>
<tr>
<td><em>U.S. Equity Benchmark</em></td>
<td>14.0</td>
<td>12.7</td>
<td></td>
</tr>
<tr>
<td><strong>Managed Futures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Graham Capital</td>
<td>6.8%</td>
<td>3.6%</td>
<td>2010</td>
</tr>
<tr>
<td>*Managed Futures Benchmark</td>
<td>3.7%</td>
<td>1.3%</td>
<td></td>
</tr>
</tbody>
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* Net of fee returns as of March 31, 2013
** Not actual BCBS performance, but PIMCO product performance
Historical Performance* (cont.)

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<th>Year of Inception</th>
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<tr>
<td><strong>Real Estate</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UBS Realty</td>
<td>7.2%</td>
<td>12.1%</td>
<td>2005</td>
</tr>
<tr>
<td>Prudential PRISA I</td>
<td>8.9</td>
<td>16.0</td>
<td>2005</td>
</tr>
<tr>
<td>Prudential PRISA II</td>
<td>10.7</td>
<td>19.1</td>
<td>2005</td>
</tr>
<tr>
<td>Private RE Benchmark</td>
<td>9.7</td>
<td>13.1</td>
<td></td>
</tr>
<tr>
<td>European Investors</td>
<td>15.6%</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Public REIT Benchmark</td>
<td>21.1</td>
<td>-</td>
<td>2011</td>
</tr>
</tbody>
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| **Alternative Fixed Income** |        |         |                   |
| PIMCO Unconstrained Bonds   | 8.0%   | -       | 2011              |
| Unconstrained Bond Benchmark | 2.4    | -       |                   |
| PIMCO StocksPlus Long Duration | 25.6%  | 25.9%   | **                |
| U.S. Equity Benchmark       | 14.0   | 12.7    |                   |

* Net of fee returns as of March 31, 2013
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NRT Historical Performance

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<th>3 Years</th>
<th>5 Years</th>
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<tr>
<td><strong>Total Fund</strong></td>
<td>11.3%</td>
<td>9.9%</td>
<td>4.4%</td>
</tr>
<tr>
<td><strong>Total Fund Benchmark</strong></td>
<td>9.5</td>
<td>8.9</td>
<td>4.2</td>
</tr>
</tbody>
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*Net of fee returns as of March 31, 2013*

*The addition of alternative investments have generally been additive to overall performance*
Additional Investment Strategies Under Consideration

- **Credit portfolio...**
  - return stream during up/down of credit cycle and interest rates
  - strategy diversity

- **Commodities...**
  - an element of inflation protection
  - diversification

- **Global macro strategies...**
  - downside protection
  - diversification
Questions
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