Investment Strategy Webinar

July 17, 2013
Presenters

Bob Penter, CFA, Partner
Pension Risk Management
Phone: 770.690.7674
Email: bob.penter.2@aonhewitt.com

Francois Otieno, Senior Consultant
GIM / Fixed Income
Phone: 312.715.3344
Email: francois.otieno@aonhewitt.com

Lucinda Downing, Sr. Research Analyst
Global Asset Allocation Team
Phone: 011 +44 207 086 9440
Email: lucinda.downing@aonhewitt.com

Saif Choudhury, Consultant
Investment Solutions
Phone: 312-715-4367
Email: saif.choudhury@aonhewitt.com

Beth Hanig, Associate Partner
Investment Consulting
Phone: 203.523.8161
Email: beth.hanig@aonhewitt.com
Discussion Topics

- Opening Remarks
- Market Outlook: Focus on Recent Volatility
- Spotlight on Fixed Income
- Thought Leadership Solution Packages Overview
- Defined Contribution Lifetime Income Solutions
- Closing Remarks

Q&A Session
Global Economic Environment Remains Weak

- Macroeconomic support for equities is not strong

- However, economic news flow has improved. Even the struggling UK and Eurozone economies have delivered positive surprises. China, however, continues to report weak economic data

- Good US jobs data and rising house prices but fiscal cuts have hit economic activity
Equities are Focused on the Short-Term

- 6% US equity market correction, but now back to all time highs - 25% on year-ago levels
- Fed’s tapering statement on May 22nd was nothing new, but markets appear to have been unprepared for it
- Market has returned to short-term focus and is once again ignoring the challenge of less stimulus in the future
- Emerging markets continue to fall but, as a consequence, valuations have become compelling

\[\text{S&P500 makes new highs}\]

\[\text{Valuations Cheapening} \]

Emerging market valuations as a ratio to developed

\[\text{Emerging markets more expensive}\]

\[\text{Emerging markets cheaper}\]

Source: Datastream

\[\text{S&P500 makes new highs}\]

\[\text{Valuations Cheapening} \]

Emerging market valuations as a ratio to developed

\[\text{Emerging markets more expensive}\]

\[\text{Emerging markets cheaper}\]

Source: Datastream
Pronounced Move Up in Bond Yields

- Bond yields rose strongly since May and are now back up to levels last reached in August 2012
- TIPS real yields are up significantly (120bp rise in real yields since April)
- Relative move indicates more confidence in the economic recovery
- We expect some correction to this upward move, although multi-year bond bear market will remain intact
- We have increased our yield expectations over next 5 years as the risk of a policy error has increased

<table>
<thead>
<tr>
<th></th>
<th>Aon Hewitt expectation</th>
<th>Market Expectation*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20yr duration</td>
<td>Increase from today</td>
</tr>
<tr>
<td>Now</td>
<td>3.5%</td>
<td></td>
</tr>
<tr>
<td>In 1yrs</td>
<td>4.0%</td>
<td>0.5%</td>
</tr>
<tr>
<td>In 3yrs</td>
<td>4.3%</td>
<td>0.8%</td>
</tr>
<tr>
<td>In 5yrs</td>
<td>4.7%</td>
<td>1.2%</td>
</tr>
</tbody>
</table>

* Based on end June 2013 yield curve
Uncertain Future is Not Fully Reflected in Markets

- Equity volatility has fallen with new highs reached by S&P 500
- Falling gold price reflects market perception of low risk of extreme events
- FX markets have been destabilized by the huge move in the Yen and emerging currencies
- Excessive bullish sentiment vulnerable to further upsets

Source: Deutsche Bank's CVIX
Which Uncertainties Dominate?

**Will global economic conditions hold up?**
Major economic downside risk is small as long as yields rise gradually

**How disruptive will the sovereign bond environment be?**
This is a bigger risk than macro risk

**Will monetary stimulus be withdrawn in an orderly way?**
QE stimulus to continue for another year as economic removal conditions not yet achieved. Move to higher rates is a long way out

We expect equities will avoid a period of sustained decline BUT underlying trend in equities is turning flatter as the risk-reward in equities has deteriorated

We don’t anticipate a bond market meltdown. Yields are likely to normalize over several years

Uncertainties around monetary policy mean that there is likely to be more equity and bond market volatility
Spotlight on Fixed Income

Francois Otieno
Fixed Income Market Review – Index Returns

Index Returns

Sources: eVestment, Barclays Live
Manager Performance by Strategy Type: Bank Loans

Bank Loans

Returns

-4.0% -3.0% -2.0% -1.0% 0.0% 1.0% 2.0% 3.0% 4.0%

June Q2 YTD

-4.0% -3.0% -2.0% -1.0% 0.0% 1.0% 2.0% 3.0% 4.0%

Sources: eVestment, Managers
Manager Performance by Strategy Type: EMD

EMD Blended

- Average Return
- JPM EMD Custom Weighted Index*
- Average Excess Return

*50% JPM EMBI Global Diversified, 40% JPM GBI-EM Global Unhedged, 10% JPM CEMBI

Sources: eVestment, Managers
Manager Performance by Strategy Type: Unconstrained

Unconstrained

Returns

-4.0% -3.0% -2.0% -1.0% 0.0% 1.0% 2.0% 3.0% 4.0%

June Q2 YTD

Average Return
Barclays Aggregate Index
Average Excess Return*
3-Month LIBOR**

Sources: eVestment, Barclays Live, Managers

*Against the Barclays Aggregate
**Standard Benchmark
Opportunities Within Fixed Income Going Forward

- Managers have generally characterized this recent sell off as a re-pricing of risk, which is vastly different from what we experienced in the last credit cycle of 2007/2008

- In general, managers are staying the course but are selectively taking advantage of investment opportunities in light of the recent market pullback

- HEK continues to advocate
  - Bank Loans;
  - EMD; and
  - Unconstrained Bond Strategies
Portfolio Implications for Switching from BC Aggregate to the BC Intermediate Index

Portfolio Implications

- Investors looking to manage the volatility of the return-seeking portfolio should consider investing the risk-reducing portfolio in intermediate fixed income
- For those that are concerned about cash flow yield, recognize the yield reduction relative to the volatility reduction is minimal
  - Reposition from Aggregate Index to Intermediate Aggregate Index
  - Shorten the duration by 1.35 years
  - Yield reduction of 30 basis points
  - One year breakeven yield change is only 22 basis points

Implementation Considerations

- Separate account clients could switch their BC Aggregate mandate to the Intermediate Aggregate Index with the same manager
- There are also a number of Mutual Fund and/or Commingled Fund options available
Defined Contribution Lifetime Income Solutions

Beth Hanig
Saif Choudhury
What is Retirement Income?

<table>
<thead>
<tr>
<th>Type of Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managed Payout—Existing Funds</td>
</tr>
<tr>
<td>Managed Payout—New Fund</td>
</tr>
<tr>
<td>Deferred Guaranteed Monthly Withdrawal Benefit</td>
</tr>
<tr>
<td>Deferred Guaranteed Monthly Income Benefit</td>
</tr>
<tr>
<td>Deferred Fixed Annuity</td>
</tr>
<tr>
<td>Traditional annuity—End of Plan*</td>
</tr>
<tr>
<td>Annuity Platform*</td>
</tr>
<tr>
<td>Longevity Insurance*</td>
</tr>
</tbody>
</table>

* Out of Plan Annuity Options
**Current Market**

- Plan Sponsor 2013 priorities (highest to lowest)*
  - Participation Rates
  - Diversification
  - Leakage
  - Savings Rates
  - Retirement Readiness
  - Distributions (retirement income)

- Regulatory / Fiduciary Issues
  - Treasury Department proposed guidance on lifetime income options
  - Government continue not to mandate, but to encourage
  - Current Safe Harbor passed in 2008 provides greater fiduciary clarity
  - Due diligence assistance is paramount
  - Counterparty risk is top of mind

* 2013 Aon Hewitt Hot Topics in Retirement
Last year, plans sponsors continued to add new lifetime income options. The largest increase was managed payout with drawdown feature (9%). In-plan annuity additions were flat.

**Plan Sponsor Adoption***

### Prevalence—Currently Available

<table>
<thead>
<tr>
<th>Feature</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Online modeling tools retirement planning</td>
<td>61%</td>
</tr>
<tr>
<td>Distributions from plan/auto payment</td>
<td>37%</td>
</tr>
<tr>
<td>In-plan managed accounts with drawdown feature</td>
<td>19%</td>
</tr>
<tr>
<td>Annuities outside the plan</td>
<td>13%</td>
</tr>
<tr>
<td>In-plan managed payout funds</td>
<td>12%</td>
</tr>
<tr>
<td>In-plan Annuity</td>
<td>10%</td>
</tr>
<tr>
<td>Ability to transfer assets to a DB plan to receive annuity</td>
<td>3%</td>
</tr>
</tbody>
</table>

### Plans for 2013 Among Those Not Already Offering

- **Online modeling tools retirement planning**
  - Very likely in 2013: 14%
  - Somewhat likely in 2013: 44%

- **Distributions from plan/auto payment**
  - Very likely in 2013: 6%
  - Somewhat likely in 2013: 18%

- **In-plan managed accounts with drawdown feature**
  - Very likely in 2013: 6%
  - Somewhat likely in 2013: 20%

- **Annuities outside the plan**
  - Very likely in 2013: 3%
  - Somewhat likely in 2013: 16%

- **In-plan managed payout funds**
  - Very likely in 2013: 2%
  - Somewhat likely in 2013: 12%

- **In-plan Annuity**
  - Very likely in 2013: 7%
  - Somewhat likely in 2013: 14%

- **Ability to transfer assets to a DB plan to receive annuity**
  - Very likely in 2013: 5%

* 2013 Aon Hewitt Hot Topics in Retirement
Fiduciary Implications

The selection of an annuity provider for benefit distributions from an individual account plan satisfies the requirements of section 404(a)(1)(B) of ERISA if the fiduciary complies with the following criteria:

Criteria for selection process includes:

1. Engaging in objective, thorough, analytical search
2. Assessing insurers future claim paying abilities
3. Considering all fees relative to benefits under contract
4. Assessing whether insurer is financially viable at time of selection
5. Consulting with expert(s) to assist with assessment as necessary
Projected Income by Age—All Options
Expected, Downside, and Upside Scenarios

Annual Income for All Options
50th Percentile

Annual Income for All Options
5th Percentile

Annual Income for All Options
95th Percentile

- 4% Systematic Withdrawal
- GMWB
- Age 65 Annuity
- Managed Account

Hewitt Ennisknupp
An Aon Company
Projected Account Balance (Bequest) by Age—All Options
Expected, Downside, and Upside Scenarios
Percentile of Income by Age—All Options
Multiple of Final Pay, Inflation-Adjusted
Our Advisory Position

- **Generally supportive of Lifetime Income options**
  - DC plans will become critical source for generating retirement income
  - Product landscape has evolved
  - Major corporations have began to implement these solutions
  - Government has provided solid fiduciary guidance and support

- **Initial concerns are being mitigated**
  - Greater fee transparency and improved portability through middleware
  - Lower counterparty risk through better risk structures
  - Design changes through integration with target date funds

- **Sponsors need to continue assessing these options**
  - Contemplate non-insurer and insurer solutions
  - Need to assess the right time to add these options
  - Assess any short term and long term fiduciary implications
# Retirement Income Implementation Plan

<table>
<thead>
<tr>
<th>Process Steps</th>
<th>Goals and Objectives</th>
</tr>
</thead>
</table>
| **Phase One: General Overview, Scoping and Asset Class Decision Making**      | • Review the current market and trends  
 • Understand the asset classes  
 • Focus on optimal plan design and participant needs  
 • Determine most suitable asset classes for further review                     |
| **Phase Two: Product Analysis and Review**                                     | • Understand detailed due diligence on asset classes  
 • Review of products and nuances  
 • Focus on plan demographics and need                                           |
| **Phase Three: Final Fiduciary Analysis, Product Manufacturer Meeting and Finalist Interviews** | • Understand Safe Harbor guidance and fiduciary implications  
 • Review benchmarking rules and participant disclosures  
 • Contemplate future on-going due diligence requirements  
 • Meet with income providers and select best solution(s)                          |
| **Phase Four: Recordkeeping and Product Implementation**                       | • Focus on Participant Experience and Integration  
 • Review Participant Communication  
 • Discuss Rollout Strategy  
 • Review and understand timeframe for Record-keeper implementation               |
Closing Remarks

Bob Penter, CFA
Question & Answer

Questions may be submitted at any time during the web seminar by typing the question in the "Ask a Question" text field and clicking "Submit." Questions will be answered live as time permits during the question and answer session.
Our next investment strategy update call is scheduled for Wednesday, August 21, at 10 a.m. CDT.