



# “Custom” doesn’t need to mean costly

## How custom, target date strategies can help balance cost and value

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In the first two articles in this series, we considered the benefits of target date funds, which have contributed to their widespread growth and adoption, and the ability of today’s custom portfolio model designs to feature a target date format. In this article, you’ll see how custom portfolio models not only offer ease, flexibility and the potential for better outcomes, they can also be created with the management of fees and costs in mind.

It is an age-old challenge: Balancing the value of including various options in a retirement plan to optimize retirement readiness versus the costs associated with them.

Plan sponsors and advisors spend considerable time carefully selecting plan options, seeking to strike the right balance between cost and value. While custom portfolio approaches are increasingly recognized for their modeling ability to meet a range of plan demographics and participant investment styles, they also offer another less understood benefit: The ability to manage program costs.

This articles examines three illustrations with key takeaways that show how plan sponsors and advisors can build custom portfolios to manage and even reduce costs. It’s important to note, however, that cost is just one element in the development of any program and needs to be considered in the context of value delivered by the program as a whole.

### **Illustration #1: A low-cost, custom, index-based portfolio strategy**

One misconception about custom portfolios is that they will result in custom (as in “high”) fees. The reality is that a properly executed custom portfolio approach can be among the lowest-cost options available in the target date strategies arena while still delivering added benefits—such as more relevant glidepaths or better diversification—of the sponsor’s choosing.

Let’s consider a hypothetical target date structure we used in a previous article. The panel on the left shows the fees associated with each age-based fund. The fees are essentially a weighted average of the underlying fees of the component funds. So, for the traditional target date-type strategy, the weighted average fee across all age-based funds is .09%, or nine basis points.

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In the panel to the right, you can see the impact on fees if a client organization, working with an advisor, decides to create a custom, target date strategy. The modified strategy mimics the traditional target date-type funds, but differs in a key way: It substitutes a hypothetical fixed annuity for the Core Bond allocation. In this example, we assume the fixed annuity has no stated fee since the fee is already built into the interest rate spread. Therefore, the 0.0% fee and the resulting calculation shows a weighted fee average across all age-based models of .05%, or five basis points.

Hypothetical target date strategy						Modified strategy		
Component fund:	U.S. Large Cap	U.S. Small Cap	International Equity	Core Bonds	Total allocations	Weighted model fees	Replacing Core Bonds with fixed annuity	Weighted model fees
Component fund fee:	0.04%	0.10%	0.15%	0.11%			0.00%	
Model allocations								
2060 Model	58.0%	6.0%	26.0%	10.0%	100.0%	0.08%	10.0%	0.07%
2055 Model	58.0%	6.0%	26.0%	10.0%	100.0%	0.08%	10.0%	0.07%
2050 Model	58.0%	6.0%	26.0%	10.0%	100.0%	0.08%	10.0%	0.07%
2045 Model	57.0%	6.0%	27.0%	10.0%	100.0%	0.08%	10.0%	0.07%
2040 Model	54.0%	6.0%	25.0%	15.0%	100.0%	0.08%	15.0%	0.07%
2035 Model	48.0%	5.0%	23.0%	24.0%	100.0%	0.09%	24.0%	0.06%
2030 Model	42.0%	5.0%	20.0%	33.0%	100.0%	0.09%	33.0%	0.05%
2025 Model	37.0%	4.0%	17.0%	42.0%	100.0%	0.09%	42.0%	0.04%
2020 Model	31.0%	3.0%	15.0%	51.0%	100.0%	0.09%	51.0%	0.04%
2015 Model	26.0%	3.0%	13.0%	58.0%	100.0%	0.10%	58.0%	0.03%
Retirement Model	22.0%	2.0%	11.0%	65.0%	100.0%	0.10%	65.0%	0.03%
Average model						0.09%		0.05%
Model advisor fee						0.00%		0.03%
Total average fee						0.09%		0.08%

Building the modified strategy has an additional cost since most plan sponsors are likely to employ an advisor to help them through this process. Here we assume a .03% advisor fee (or three basis points). That brings the total fee for the modified strategy to .08%, or eight basis points, which is slightly less than the hypothetical target date option.

In this side-by-side comparison, it’s true the custom option only represents a modest fee reduction, but it also provides the added value of a lifetime income feature. A key takeaway: A better strategy need not be a more expensive one.

### Illustration #2: Blending active and passive funds

In this next illustration, a hypothetical advisor intends to build a target date strategy using a custom portfolio. This advisor has a definite point-of-view around fund composition and believes strongly in including several active funds. At the same time, wary of fund managers’ ability to add value in certain asset classes, this advisor also plans to use index funds.

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In the recommended portfolio detailed below, the advisor is able to blend a combination of both active and passive (index) funds. Like the previous example, this custom portfolio also provides a lifetime income feature by including a fixed annuity. Along with model fees (second column from the right), which show the component costs of the underlying funds, the last column shows an sample expected value-add level for each component (This is an illustrative example of the advisor’s opinion of value-add potential from these funds). While the index (passive) components would typically be expected to have zero value-added, active strategies have the ability to add value with higher potential returns, which have the opportunity to be significant to a participant’s retirement account over time.

Hypothetical active-passive custom target date portfolio										
Component fund	U.S. Large Cap Index	U.S. Active Growth	U.S. Active Value	Active U.S. Small Cap	International Equity Index	Active Global Fixed Income	Fixed annuity	Total allocations	Model fees	Expected value added
Fee	0.04%	0.46%	0.35%	0.06%	0.11%	0.55%	0.00%			
Expected value added	0.00%	0.75%	0.75%	1.35%	0.00%	1.25%	0.00%			
2060 Model	20.0%	19.0%	19.0%	6.0%	26.0%	3.0%	7.0%	100.0%	0.21%	0.40%
2055 Model	20.0%	19.0%	19.0%	6.0%	26.0%	3.0%	7.0%	100.0%	0.21%	0.40%
2050 Model	20.0%	19.0%	19.0%	6.0%	26.0%	3.0%	7.0%	100.0%	0.21%	0.40%
2045 Model	19.0%	19.0%	19.0%	6.0%	27.0%	3.0%	7.0%	100.0%	0.21%	0.40%
2040 Model	18.0%	18.0%	18.0%	6.0%	25.0%	4.0%	11.0%	100.0%	0.21%	0.40%
2035 Model	16.0%	16.0%	16.0%	5.0%	23.0%	7.0%	17.0%	100.0%	0.20%	0.40%
2030 Model	14.0%	14.0%	14.0%	5.0%	20.0%	8.0%	25.0%	100.0%	0.19%	0.38%
2025 Model	13.0%	12.0%	12.0%	4.0%	17.0%	9.0%	33.0%	100.0%	0.17%	0.35%
2020 Model	11.0%	10.0%	10.0%	3.0%	15.0%	15.0%	36.0%	100.0%	0.19%	0.38%
2015 Model	10.0%	8.0%	8.0%	3.0%	13.0%	15.0%	43.0%	100.0%	0.17%	0.35%
Retirement Model	10.0%	6.0%	6.0%	2.0%	11.0%	15.0%	50.0%	100.0%	0.15%	0.30%
Average model:									0.19%	0.38%
Add: Advisor fee:									0.03%	
Total fees:									0.22%	
<u>Net expected value added:</u>										<b>0.16%</b>

Even after factoring in the advisor fee, the expected net value added of the proposed custom solution is in excess of a passive index-based strategy by 0.16%. Key takeaway: Adding substantial value doesn’t have to add substantially to costs.

### Illustration #3: Building a “best-in-class” solution

One of the most frequently cited reasons for creating a custom portfolio is that an advisor can bring a “best in class” lineup to a target date design with the hope of delivering superior performance across the board. While the concept is simple, the execution is another thing, in part because predicting the “best” in terms of performance is problematic, to say the least.

Nevertheless, it’s a worthwhile goal, and the example illustrates how this can be done. This set of models is made up of actively managed strategies with high levels of expected value added over some future time period. Like the previous two examples, these custom models also include an allocation to a fixed annuity for low-volatility accumulation and potential for post-retirement income. Remember, the fixed annuity has the associated cost built into the interest rate spread so there is no fee shown.

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After deducting the average model costs even for these actively managed options and the advisor fee, this hypothetical solution still has a net value added after fees is 1.06% based on the hypothetical advisor’s assessment of the funds’ ability to add value. Key takeaway: You’re in control. You can choose the components and determine whether the degree of expected value add is worth the higher level of fees.

Hypothetical “best in class” custom target date portfolio											
Component fund	U.S. Active Growth	U.S. Active Value	Active U.S. Small Growth	Active U.S. Small Value	Active Intl. Equity	Active Emerging Markets	Active Core Fixed Income	Fixed annuity	Total allocations	Model fees	Expected value added
Fee	0.71%	0.35%	1.28%	0.95%	0.97%	1.13%	0.45%	0.00%			
Expected value added	1.42%	1.80%	3.10%	2.56%	1.96%	3.07%	1.74%	0.00%			
2060 Model	20.0%	19.0%	19.0%	6.0%	18.0%	8.0%	5.0%	5.0%	100.0%	0.80%	2.05%
2055 Model	20.0%	19.0%	19.0%	6.0%	18.0%	8.0%	5.0%	5.0%	100.0%	0.80%	2.05%
2050 Model	20.0%	19.0%	19.0%	6.0%	18.0%	8.0%	5.0%	5.0%	100.0%	0.80%	2.05%
2045 Model	19.0%	19.0%	19.0%	6.0%	20.0%	7.0%	5.0%	5.0%	100.0%	0.80%	2.05%
2040 Model	18.0%	18.0%	18.0%	6.0%	20.0%	5.0%	7.5%	7.5%	100.0%	0.76%	1.97%
2035 Model	16.0%	16.0%	16.0%	5.0%	18.0%	5.0%	12.0%	12.0%	100.0%	0.71%	1.85%
2030 Model	14.0%	14.0%	14.0%	5.0%	16.0%	4.0%	16.5%	16.5%	100.0%	0.65%	1.74%
2025 Model	13.0%	12.0%	12.0%	4.0%	14.0%	3.0%	21.0%	21.0%	100.0%	0.59%	1.61%
2020 Model	11.0%	10.0%	10.0%	3.0%	12.0%	3.0%	25.5%	25.5%	100.0%	0.53%	1.49%
2015 Model	10.0%	8.0%	8.0%	3.0%	10.0%	3.0%	29.0%	29.0%	100.0%	0.49%	1.40%
Retirement Model	10.0%	6.0%	6.0%	2.0%	8.0%	3.0%	15.0%	50.0%	100.0%	0.37%	1.00%
Average model:										0.66%	1.75%
Add: Advisor fee:										0.03%	
Total fees:										0.69%	
<u>Net expected value added:</u>											<u>1.06%</u>

### Are you ready for more flexibility, control and value?

As you can see, the custom portfolio model examples shown above don’t have to add substantially to retirement program costs; in fact, custom portfolio models can help advisors and sponsors even reduce costs compared to the standard target date default option. Importantly, they also have the potential to deliver greater portfolio value to retirement plan participants, which can improve retirement readiness and deliver better outcomes.

The three examples help to illustrate the flexibility of custom portfolios in incorporating different investments and investing styles so sponsors and advisors can devise solutions that reflect their plan’s unique nexus between cost and value. Whether you’re seeking the lowest-cost alternative or a high value-add strategy, a custom portfolio allows you to choose.

For additional information about TIAA’s custom portfolio services, read the first two articles in this series. To see how a custom portfolio can support your plan’s and participants’ goals, please contact your TIAA representative.



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