FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
77 K Street, NE Washington, DC 20002

THRIFT SAVINGS PLAN

December 16, 2013

MEMORANDUM FOR: Board Members, Kennedy, Bilyeu, Jones, McCray and Jasien

FROM: Greg Long, Executive Director

SUBJECT: L Fund Default Investment Option

BACKGROUND

Currently, new TSP participants are defaulted into the Government Securities Investment Fund (G Fund) and remain invested in this fund until they make an election reallocating their account balance or directing their contributions into one or more of the other funding options available in the TSP.

In April 2013, the Office of Enterprise Planning (OEP) reviewed changing the default investment option for new participants joining the Thrift Savings Plan (TSP). Since the April report, the Agency has examined additional participant demographic data as part of an effort to better understand participant investment behaviors. Additionally, the Agency's investment consultant has completed an analysis that also informs this discussion. This report updates the April report with additional information relating to the recommendation to change the default investment option to the appropriate Lifecycle Fund (L Fund).

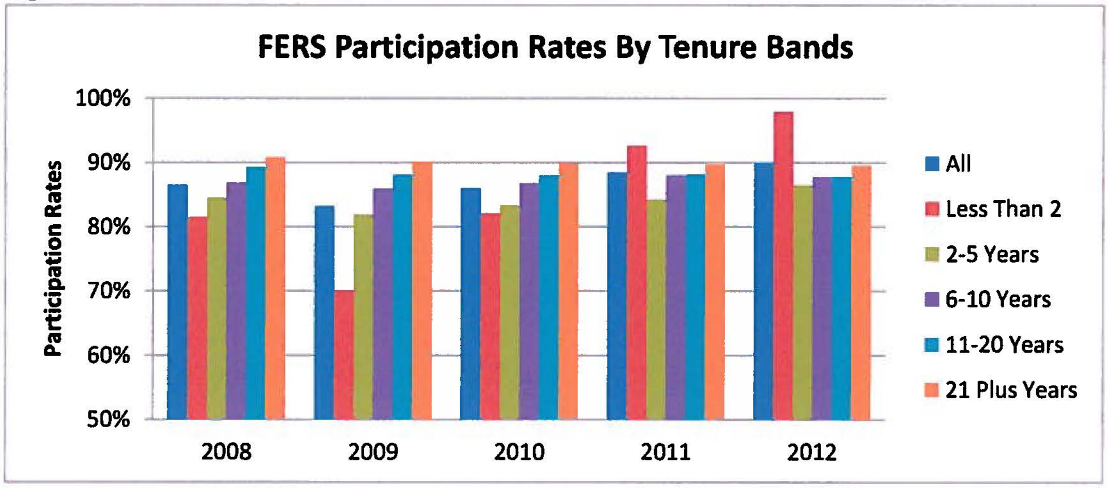
To recap, the Thrift Savings Plan Enhancement Act of 2009 enabled auto-enrollment of new Federal employees into the TSP. Since August 2010, all new Federal employees automatically have 3% of their base salary contributed to the TSP unless the individual actively elects **not** to participate in the TSP or elects to participate at a different deferral rate. Contributions for auto-enrolled participants default into the G Fund.

An automatic 1% contribution is made into the TSP by the employing agency for all FERS employees. These contributions are defaulted into the G Fund and remain in that allocation until the individual makes a different allocation decision. Consequently, there are two sources of accounts that default into the G Fund: accounts established for individuals automatically enrolled into the Plan and those with agency automatic 1% contributions. As of September 30th, auto-enrolled accounts with no subsequent investment activity totaled about 114,000 and accounts with agency-only contributions totaled 321,000. It is important to note that any change in the auto-enrollment default option will **not** impact the accounts currently in this status. The change would only impact the default investment for future accounts. Our Office of Communications and Education has targeted communications designed to encourage the existing defaulted participants to "engage" by selecting an appropriate L fund.

PARTICIPANT DEMOGRAPHICS

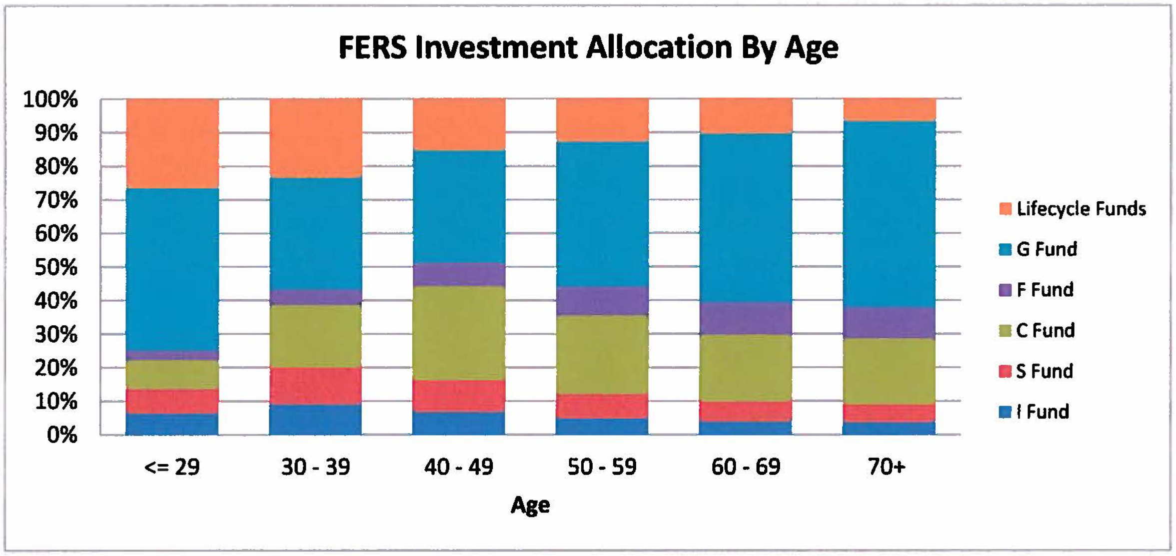
We examined our participation rates over a five-year period and quickly identified the impact of automatic enrollment on certain demographics.

Figure 1



Historically, participation in the TSP has been highest among the longest-tenured employees. For example, in 2008, the participation rate of FERS employees with 21 or more years of tenure was 90.8% as compared to 81.5% among employees with less than two years of tenure. After two years of automatic enrollment, this pattern has been meaningfully altered. Participation is now highest, at 97.9% among employees with less than two years of tenure, and for those with 21 or more years, participation is at 89.6%.

Figure 2



In viewing Figure 2, we continue to note that allocations to the G Fund appropriately increase as the age of the TSP's population increases. This behavior is consistent with the expectation that participants shift their investment allocation towards the relative safety of income producing assets as they approach retirement age. The noteworthy exception to this observation is in the grouping of participants aged 29 and under. In this age cohort, we continue to note that participants invest a disproportionate percentage (48%) of their accounts in the G Fund. In comparison, the Employee Benefit Research Institute (EBRI) reports that the average asset allocation to similar conservative investments (Money Markets, GICs, and Stable Value Funds) for 401(k) participants in their 20s is 6.2%.[1]

It is commonly recognized that younger participants have a more difficult time envisioning their need for retirement saving and planning and therefore are less likely to actively manage their retirement accounts. This inertia is likely a strong contributor to this demographic group remaining in the default option. If participants entering the TSP were invested in an age-appropriate L Fund, their contributions would be allocated across the equity markets and include a smaller allocation to the G Fund. As the draw down date approaches, allocations automatically change to include higher percentages of the G Fund. With about 30-40 years to retirement, this group has an investment horizon that should allow its members to participate in the markets and "weather" its cycles.

[1] Jack VanDerhei, et al., "401(k) Plan Asset allocation, Account Balances, and Loan Activity in 2011," EBRI Issue Brief No. 380 (2012): Page 23.

INVESTMENT CONSIDERATIONS

The table below compares returns of the L Funds and G Fund, since inception and since the implementation of auto-enrollment, through September 30, 2013.

Figure 3

Fund	Returns since inception of L Funds Aug 2005 – Sep 2013	Returns since inception of Automatic Enrollment Aug 2010 – Sep 2013
G Fund	29.75%	6.33%
L Income	41.74%	16.35%
L 2020	56.96%	34.12%
L 2030	62.32%	41.64%
L 2040	65.78%	47.39%

Since August 2005 (which includes the market downturn of 2008-2009), cumulative returns of the L Funds ranged from 41.7% for L Income, the most conservative option, to 65.8% for L 2040, the most aggressive option (L2050 has only been available since the beginning of 2011). This compares to a return of 29.8% for the G Fund, over the same period. A similar pattern of returns is observed over the period since the inception of auto-enrollment. While "past performance is not a guarantee of future results," it is apparent that the well-diversified allocations of the L Funds outperformed the G Fund, albeit with a greater risk.

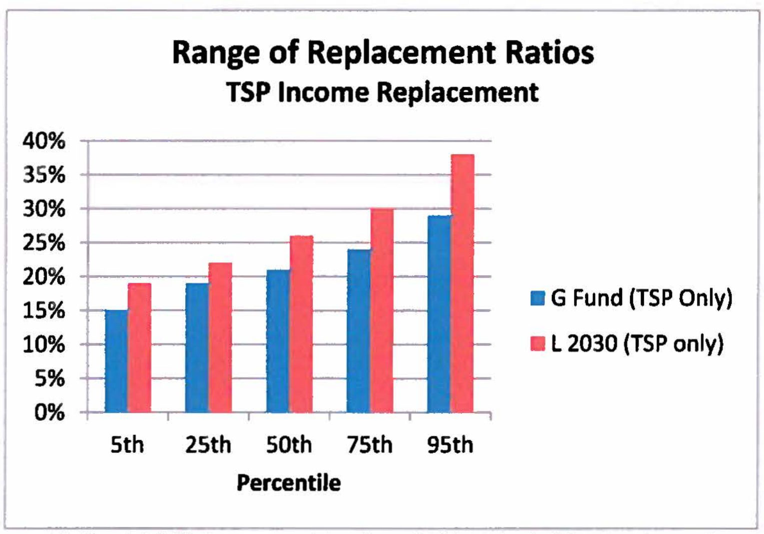


Figure 4

As a part of the Lifecycle Fund asset allocation review performed by our investment consultant, a simulation of potential returns was performed. This stochastic (Monte Carlo) analysis simulated the performance of hypothetical portfolios invested during a wide variety of economic scenarios. When modeling a "typical" TSP participant, currently aged 44 and retiring at age 61, the analysis projected that a portfolio 100% invested in the G Fund yielded a less favorable distribution of outcomes (i.e., account balance, replacement ratio) than the outcomes of a portfolio invested in the L Fund. As noted in Figure 4, the median outcome of the 100% G Fund portfolio resulted in a smaller replacement ratio (percentage of final pay replaced by retirement income) than the median Lifecycle fund outcome, and the same holds true at the 5th percent outcome, 25th percent outcome, etc. For example, the median outcome for a participant investing in the L2030 Fund is a TSP-only replacement ratio of 26% of income. If the same person had invested 100% in the G Fund, the median outcome is a 21% TSP replacement of income.

There will be periods when the G Fund will outperform one or more of the L Funds; however, over time, the L Funds are more likely to provide better investment performance to participants than a 100% investment in the G Fund. Had the Lifecycle Funds been the default investment option since the start of auto-enroll, participants who remained invested during the entire period would have achieved greater investment returns and consequently, greater account balance growth than achieved by investing solely in the G Fund.

ADDITIONAL CONSIDERATIONS

As addressed in the April, 2013 memo, changing the default option from the G Fund to the appropriate L Fund will require only limited changes to the Plan's recordkeeping system, with costs estimated in the range of $150,000 - $200,000.

However, implementing the L Fund default investment will require a legislative change. The TSP is governed by FERSA, not ERISA. Consequently, the Pension Protection Act of 2006 (PPA) authorization of Qualified Default Investment Alternatives (QDIA)[2] and the Department of Labor's (DOL) interpretive guidance do not authorize the TSP to establish the lifecycle funds as its default option. In order to establish the L Funds as the default option, Congress would need to amend FERSA (5 U.S.C. § 8438(c)(2)) to change the default option and amend FERSA's acknowledgment of risk provision (5 U.S.C. § 8439(d)) to make it clear that an investment in the default fund would not require an acknowledgement of risk.

RECOMMENDATION

The L Funds, offer professionally managed allocations across asset classes and are designed to maximize expected performance for the amount of risk taken. The design of the L Funds automatically addresses changing asset allocation needs as participants near their draw-down dates. While investing in an L fund exposes a participant to the risk inherent in the capital markets, the L Funds appropriately address those risks in their design. Further, those participants who conclude they do not want to assume market risk will always have the ability to change their allocations or move their account balances to the G Fund.

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[2] The final DOL regulation provides for four types of QDIAs:

- A product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund);
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally-managed account);
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and
- A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax).

Implementing a default to the appropriate L Fund will represent a significant step forward in combating the negative impact of inertia. Additionally, changing the default option to an age-appropriate L Fund helps ensure that the contributions of TSP participants are invested in a fund that gives them a better chance of being prepared for retirement than investing in the G Fund over the course of their career.

Thus, it is my recommendation, that the board adopt a policy that the default investment option for the TSP should be changed to the age-appropriate L Fund from the G Fund. I further recommend that the Board adopt a resolution to seek legislative action to effect this policy change.

ETAC

The content of this memo was shared with the Employee Thrift Advisory Council (ETAC) on November 18, 2013. After discussion, the ETAC Chairman, Mr. Clifford Dailing, expressed the unanimous support of the Employee Thrift Advisory Council in effecting this change.