



## FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

77K Street, NE Washington, DC 20002

### MEMORANDUM TO BOARD MEMBERS KENNEDY, BILYEU, JONES, MCCRAY, AND JASIEN

FROM: Ravindra Deo *Ravindra Deo*  
Acting Executive Director

DATE: May 22, 2017

SUBJECT: Investment Option Review by Aon Hewitt Investment Consulting; summary and recommendations

#### INTRODUCTION:

The FRTIB requested that Aon Hewitt Investment Consulting (AHIC) conduct a review of the current menu of individual investment options in the TSP and determine if these continue to be in the best interest of participants and beneficiaries. AHIC considered the TSP's enabling statute, its size, liquidity needs, market coverage, opportunities for diversification and other factors. The investment consultant also examined the public and private sector defined contribution landscape for best practices. As a result, it determined that the TSP's current individual investment fund line-up includes all of the core building blocks for participants to build broadly diversified investment portfolios that span the risk and return spectrum. It did not recommend any additional stand-alone investment options. The TSP's Lifecycle Funds composition provides a reasonable set of automatic options for participants that wish to delegate their investment allocation decision, according to AHIC.

#### DISCUSSION:

AHIC made two recommendations.

1. The TSP should implement five-year increments for the L Funds in order to be more in line with current market standards and to provide participants with glide path terminal points that are, on average, better customized to their specific time horizons.
  - a. We previously have had discussions with the Board and agree that L Funds with five-year increments are more in line with best practices, and

would provide a broader range of alternatives for participants and beneficiaries.

2. The TSP should consider changing the mandate for the I Fund to include the stocks of Canadian companies, emerging markets companies, and non-U.S. small capitalization companies as part of a broad non-U.S. stock offering. The rationale for this recommendation encompasses a number of reasons worth enumerating.
  - a. Canadian stocks – Canadian stocks comprise the third largest stock market outside of the United States. Their inclusion would complete the set of developed nation companies that currently form the benchmark index (MSCI EAFE) for the I Fund.
  - b. Emerging markets stocks – Inclusion of emerging markets stocks would provide access to an additional broadly diversified set of countries, industries, and companies that potentially represent some of the fastest growth opportunities in the world.
  - c. Non-U.S. small capitalization stocks – Investment in small capitalization stocks often provides exposure to faster growing companies than those available in large and mid-capitalization benchmarks, creating opportunity for greater returns on average than those returns available from more mature, larger companies. In addition, they add a large amount of diversification simply by introducing a greater number of companies overall. Including non-U.S. small capitalization stocks would be in line with the entire market approach currently used for U.S. markets.
  - d. Broad non-U.S. stock – In total, the group of countries and companies proposed for inclusion represent an opportunity to complete the broadest possible international equity market exposure to non-U.S. stocks. This parallels the philosophy already in place for U.S. market exposure, that being to offer an overall market experience. The key benefit of the inclusion of Canadian, emerging markets, and small capitalization stocks in the I Fund's benchmark is much greater diversification that will change the number of countries to 45 from 21 and the number of stocks from over 900 to over 6,000. Because of the additional opportunity for more rapid growth resulting from both the inclusion of emerging markets stocks and small capitalization stocks, AHIC suggests that better overall risk adjusted returns may result. It cites that providing all of this as a single investment option is in line with current industry practice.

## **CONCLUSION:**

As a result of the above review and recommendations by AHIC, I am:

1. Asking for the Board's approval to add L Funds in five-year increments in the year 2020.
2. Asking for the Board's approval for the FRTIB to move forward with exploring changing the I Fund's benchmark index to one that includes Canadian and emerging markets stocks as well as small capitalization stocks of the world's developed and emerging markets countries as part of an overall benchmark index study for the F, C, S, and I Funds. The study would include an assessment of the administrative and management expenses, transition costs, and timeframe for implementation of a new benchmark index as well as the identification of custody matters, liquidity concerns, and other issues that might impact the feasibility of the I Fund tracking a broader index.