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

November 20, 2017

MEMORANDUM FOR EXECUTIVE DIRECTOR RAVINDRA DEO

FROM: SEAN MCCAFFREY
DEPUTY CHIEF INVESTMENT OFFICER

SUBJECT: LIFECYCLE FUNDS 2017 ANNUAL ASSET ALLOCATION REVIEW BY MERCER INVESTMENT CONSULTING

SUMMARY

This memorandum summarizes the Office of Investments' comments on the recently concluded Lifecycle Funds annual asset allocation review conducted by Mercer Investment Consulting.

As a result of the review, Mercer proposed glide path alternatives for consideration across both "to retirement" and "through retirement" L Fund approaches that it believes may offer better financial outcomes for participants.

We have considered alternatives of adding equity along the Funds' glide paths, changing the mix of fixed income allocations, and making multiple changes in extended "through retirement" glide paths and have concluded that the financial outcomes in this year's review are not compelling enough that modifications are warranted at this time in light of the risk/reward tradeoffs identified by Mercer as well as other important factors. Therefore, we do not recommend changing the L Funds' current glide paths.

BACKGROUND

The Office of Investments policies and procedures for the Lifecycle Funds direct that "the Agency will conduct a comprehensive review of the Lifecycle Fund asset allocations at least annually, or as economic conditions require." Further, "the TSP Lifecycle Funds are designed to be a long term, risk efficient strategy, and the risk and return objectives of the funds are intended to be consistent with an overall replacement rate (including defined benefit and Social Security) of a substantial portion of pre-retirement income," according to procedures.

Mercer developed a set of capital market assumptions for items such as economic growth, inflation, interest rates, and others as well as TSP individual Funds' expected returns, risk, and correlations. The firm examined the Lifecycle Funds' current placement relative to the efficient frontier. It considered TSP characteristics and population demographics for FERS employees, especially L Fund investors. It also developed a set of glide paths over which it conducted stochastic analysis and compared predicted outcomes to those predicted for the current glide paths. Finally, Mercer considered its own quarterly survey of target date funds. All of these were among the inputs in to its process of arriving at Lifecycle Fund glide path alternatives for consideration by the TSP.

DISCUSSION

Mercer's Board summary of its asset allocation review for the TSP highlighted outcomes and risks for a typical FERS employee L Funds investor who would be invested in the Lifecycle Fund 2040. The illustration included the current glide path and several alternatives across "to retirement" and "through retirement" Lifecycle Fund designs. Two of these alternatives received further focus in the Board summary report. The analytical results evidenced modest estimated improvements over the current glide path both in account balances at retirement and in replacement ratios. Measurements of increased longevity (estimated time to depleting defined contribution assets) showed some improvement as well. However, Mercer pointed to increases in risk of loss in the final two years before retirement.

Given any modest benefits to increasing equity allocations coupled with commensurate increases in risk, Mercer indicated that the TSP review the benefits of an increase in equities subject to risk tolerance, as previously cited, across the Lifecycle Fund 2020 through 2050 glide paths in a "to retirement" design. It also suggested the TSP consider an increased equity allocation accompanied by higher proportions of I Fund and F Fund in a plus ten-year "through retirement" design, continuing to favor the "through retirement" glide path approach over the "to retirement" approach, given some evidence that many participants delay receipt of their TSP balance distributions to periods well past their retirement dates. This year, Mercer also added an alternative that models the L Funds using the median growth allocation of its target date fund universe, essentially a "through retirement" approach as well.

We believe that Mercer's rationale considered 1) the firm's conviction that, over the long run, a greater proportion of equities for the TSP Lifecycle Funds may lead to better outcomes and 2) a perceived desirability of being closer to the universe of target date funds allocations to "growth" assets. Note that in the Mercer universe, "growth" encompasses much more than simply equities used currently by the TSP; it spans a number of different asset classes.

We have no argument with the first point; holding higher proportions of equities over the long term should lead to better financial outcomes. The question is simply one of how much risk participants should take around the years of retirement.

We have mentioned in past years that the target date fund universe allocation to growth assets is not necessarily a driver for our decision. The TSP Lifecycle Funds are not meant to compete with these. It has been considered appropriate historically for the TSP L Funds, as part of the three legged stool supporting retirement income, to endeavor to provide a reasonable level of replacement income.

It's notable that this year's adoption of age 62 over age 61 as the average retirement age added significantly more to achieving better financial outcomes. Recall that we had in the past observed evidence that the FERS average retirement age had migrated higher and that, as a result, we adopted 62 as a more accurate representation of participant behavior. In addition, we determined that it would be appropriate to focus our analysis for this study on those participants who are already owners of L Funds. This was intended to ensure that the analysis to determine future L Fund glide paths would rely on the employee population demographic data of those who would be impacted. This group exhibits markedly higher average deferral rates than had been observed in the overall FERS population, a factor that certainly contributed to the better financial outcomes, reinforcing the point that the actions most additive to higher income replacement ratios and longevity of defined contribution savings for future retirees are greater savings rates and working longer. In fact, these are so impactful that the benefits of participants taking on greater risk both under "to retirement" and "through retirement" approaches are less remarkable in comparison.

Factors influencing our view to keep the L Fund glide paths unchanged are similar to previous years and include the following:

- Marginal benefits—Increased equity scenarios in both "to retirement" and "through retirement" L Fund designs were given additional consideration across the Funds. The outcomes were not particularly compelling relative to already reasonably favorable outcomes for the 2030 through 2050 Lifecycle Funds under the current glide paths. The timeframe for the Lifecycle 2020 Fund is much too short to even give similar consideration.
- Replacement income objectives—Mercer's projections, using current glide paths, demonstrate that the Lifecycle Funds, as part of the three legged stool supporting retirement income, should deliver replacement income at reasonable levels. This is especially true in light of the higher average retirement age and average deferral rates.
- Demographic data—Similar to the previous year's study, the traditional source of some important demographic data was unavailable for the 2017 analysis, leading us to access an alternate source in the TSP participant recordkeeping system. We have increasing confidence in the use of this data set, including the narrower FERS population segment of existing L Fund investors, and expect to continue to rely on this in the future.
  We believe that it's important to continue to examine the L Fund participant data set in future years as it evolves, given the L Funds introduction as the FERS default option in 2015 and as the default option for the upcoming Uniformed Services Blended Retirement in 2018. Compatibility and comparability of these two populations will require examination.
- "Through retirement" policy change – To the extent the risk return benefits of instituting increased investment risk into the Lifecycle Funds glide paths are deemed favorable, that would be more apparent in the "through retirement" alternative. Given the Lifecycle Funds focus on meeting the needs of a very broad population, we would want to see very conclusive evidence

that the needs of that population are largely concentrated around receiving distributions beginning well past (ten years, for example) retirement age before we would be comfortable recommending that policy change. As Mercer points out, “through retirement” designs can add volatility around retirement. We stated in the past that we are concerned with the potential impact on the sentiment of participants about to retire.

- TSP Lifecycle Fund returns—Examination of historical five-year annualized returns vs Mercer’s target date fund universe reveals mostly favorable results.
- Market valuation—Mercer believes that equities continue to be overvalued on a PE ratio basis. As very long term investors, we take the comment as informational only and do not have serious concerns at this time.

In consideration of the above, we do not believe this is the appropriate time to increase the Lifecycle Funds risk allocations through either “to retirement” or “through retirement” approaches.