MFS® White Paper

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Back to Reality

The important role of active management in defined contribution plans

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Why Active Now?

While active management has always played an important role in retirement plans, today's environment has added new layers of complexity to the active versus passive debate. With returns likely to be lower in the coming years than over the past decade, and environmental, social and governance (ESG) issues growing in importance for retirement plan sponsors, we believe that skilled active management will be critical to helping plan sponsors and members sort through these complex issues as they work towards positive retirement outcomes.

In brief

In this paper, we discuss three common misconceptions that have led to the increased prevalence of passive investments in defined contribution (DC) plans. To help fiduciaries weigh the pros and cons of active management, we perform a reality check on each misconception, referencing fiduciary principles and market and member survey data.

Here are the three misconceptions : 1) Passive investments result in better retirement outcomes; 2) future investment returns will be similar to historical ones; 3) sustainable investing is not aligned with fiduciary responsibility.

Misconception #1: Passive investments result in better retirement outcomes

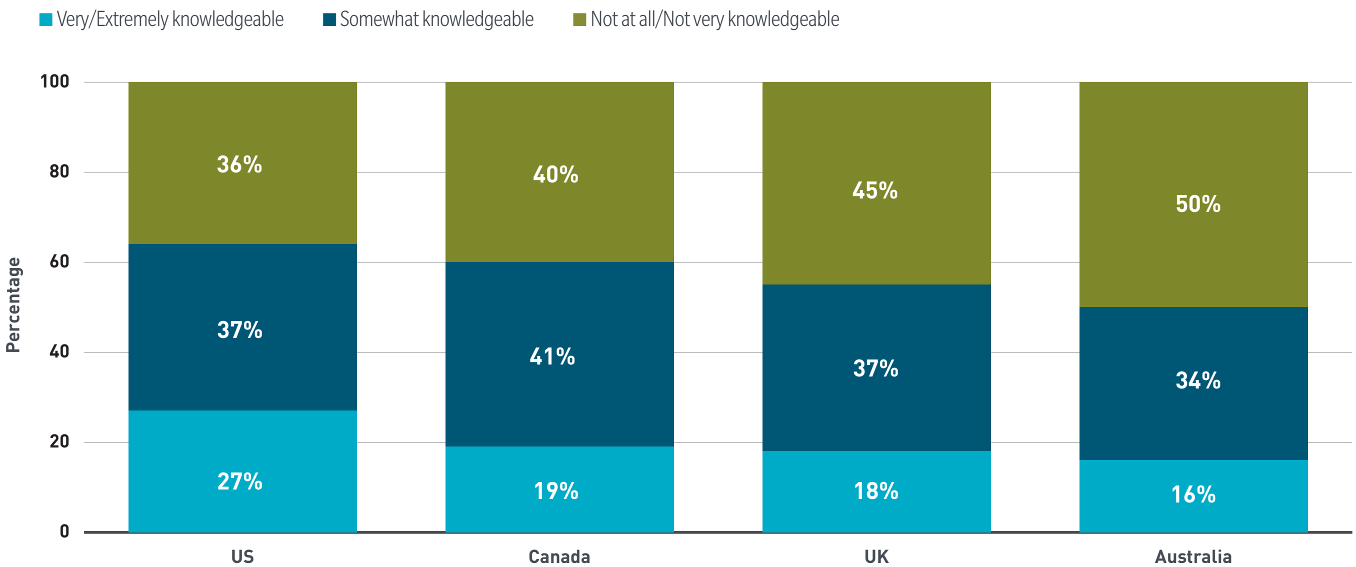
There is no denying that passive investments offer attractive fees, and those fees and the performance of those investments relative to their active counterparts are valid factors for fiduciaries to consider when deciding between active and passive funds for inclusion on DC menus. Fiduciary frameworks, however, are generally focused on process rather than outcomes, and on following and documenting that process consistently. While there are differences in fiduciary standards around the world, they typically follow one or more of these general principles:

- Make decisions that are in the best financial interests of plan members and their beneficiaries.
- Understand the provisions that govern the plan, along with all relevant local laws and regulations.
- Follow Prudent Person principles when making decisions.[1]
- Understand the risks inherent in the investments chosen for the plan.

Fiduciary standards generally give plan sponsors wide latitude in selecting investment options and do not advocate for either active or passive strategies. In general, fiduciaries are not explicitly tasked with reducing investment fees; rather, they need to regularly evaluate whether the fees paid are commensurate with the value being derived by the plan member. For example, an actively managed fund that charges a 50-basis-point fee but consistently earns a return 1% higher than a comparable passive fund over a long time horizon could reasonably be considered to be in the best interest of plan members.

Adding further complexity to the role of a fiduciary is members' mixed understanding of active and passive investments. In April 2023, MFS® conducted a global survey of DC members covering a number of topics, including active management. Survey respondents were asked to describe their understanding of active management, revealing that it is poorly understood across all four countries surveyed. Responses ranged from a high of 27% (United States) to a low of 16% (Australia) of members describing themselves as very or extremely knowledgeable about active management. In the US and Canada, 36% and 40%, respectively, reported having little or no knowledge of active management. Furthermore, only 42% of Canadian respondents indicated it was 'easy for them to tell the difference between an active or passive fund' on the investment menu.

Exhibit 1: Member understanding of active management



Source: MFS 2023 Global Retirement Survey. Q: How would you describe your level of understanding of the term 'active management' related to investing? See endnotes for more detail.[2]

The data suggest that the assumption that members can differentiate between active and passive options is fundamentally flawed, yet more and more plan menus are asking them to do just that. This is a problem that education alone cannot solve. Turning back to first principles, fiduciaries need to make decisions that are in the best financial interests of plan members, which puts the onus on those fiduciaries to construct a lineup that has the best chance of delivering beneficial outcomes at a reasonable cost.

Default options, such as target date funds, bring another dimension to the discussion of fiduciary responsibility. Within the target date fund universe is a wide range of practices in glide path design and asset allocation, resulting in a wide array of potential retirement outcomes for members.

When assessing target date funds, it is critical for plan sponsors to look carefully at the investment process, glide path shape and asset allocation throughout the member's career. In each of these areas, there are key decision points, as shown in the exhibit below.

Active decisions for all target date managers

INVESTMENT PROCESS	GLIDE PATH	ASSET ALLOCATION
Strategic vs. tactical	Steepness	Breadth of sub-asset classes
Capacity within underlying strategies	Beginning/Ending equity allocation	Use of alternative asset classes
Frequency of rebalancing	Changes to the glide path over time	Illiquid assets

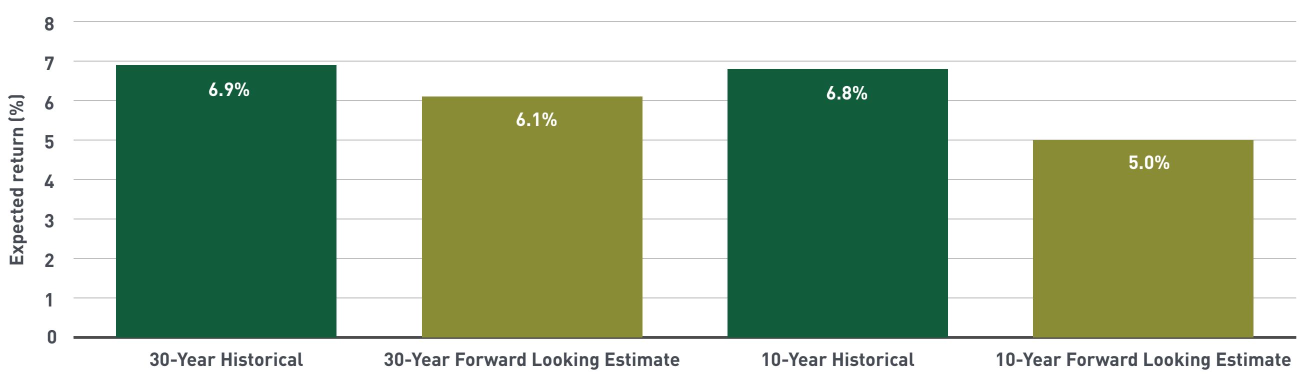
These fundamental design decisions will likely have far more impact on retirement outcomes than potential fee savings realised by taking a passive approach.

Reality #1: Fiduciaries should not simply choose the least expensive funds for plan members; rather, they should follow a well-documented, process-oriented, 'fee for value' framework for fund selection. This advice becomes even more important when looking at target date funds, for which glide path design, asset allocation and investment process are the drivers of successful retirement outcomes.

Misconception #2: Future investment returns will be similar to historical ones

A combination of consistent savings behaviour, time horizon and strong investment returns is necessary to potentially deliver positive retirement outcomes for DC members. Focusing on the return part of that equation, our most recent *Long-Term Capital Market Expectations* estimates that future returns could be significantly lower than in the past.

Exhibit 2: Estimated returns for a hypothetical 60/40 portfolio



Source: Factset. *MFS Long Term Capital Market Expectations*. Historical performance is for trailing 10- and 30-year periods as at 31 December 2023. Allocation assumed to be 40% global equity, 20% Canadian equity, 40% Canada Universe Bonds. Asset class proxies: Global Equity – MSCI World Index ($net), Canada equity – MSCI Canada Index ($Net), Canada Universe Bonds – FTSE Canada Universe Index. Please refer to the endnotes for more information on the methodology used for forward-looking assumptions. Expected return assumptions based on MFS research and *MFS Long Term Capital Market Expectations* as of January 2024. Forward-looking expectations are annualised geometric total return. The forecasts are for illustrative purposes only and are not to be relied upon as advice, interpreted as a recommendation or be guarantees of performance. The forecasts are based upon subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are based not on actual transactions but on models and data compiled by MFS. The results do not represent and are not indicative of actual results that may be achieved in the future.

Based on these assumptions, we estimate that a hypothetical portfolio of 60% equities and 40% bonds will return approximately 5% over the next 10 years and 6.1% over the next 30 years. This compares to returns of 6.8% and 6.9% experienced over the past 10 and 30 years, respectively. Considering potential future returns for both a shorter- and longer-term time horizon is important as members at different phases of the retirement savings journey may need to take different actions to achieve their retirement objectives.[3] This means that active management could have an important role to play in the years ahead as members may need additional returns to meet their goals.

To illustrate this point, we analysed two hypothetical members; Member X, age 35, in the accumulation phase of the retirement savings journey with a 30-year time horizon until retirement and Member Y, age 55, in the consolidation phase of the retirement savings journey with a 10 year-time horizon until retirement, as shown in Exhibit 3 below.

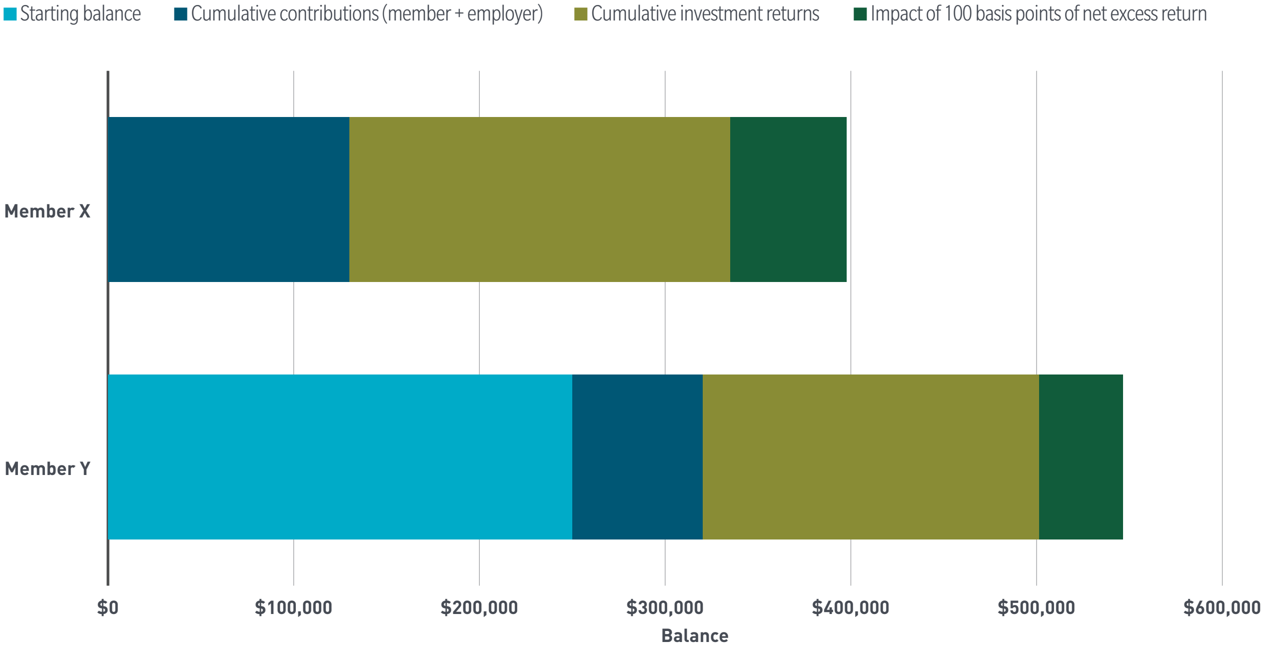
Exhibit 3: Hypothetical members: Assumptions used for modeling

Member	X	Y
Age	35	55
Salary	$40,000	$80,000
Starting Account Balance	$0	$250,000
Retirement Savings Journey Phase[3]	Accumulation	Consolidation
Employee Contribution	4% of salary	10% of salary
Employer Match	100% on the first 4%	100% on the first 4%
Asset Allocation	60% equity/40% fixed income	60% equity/40% fixed income

For simplicity, both hypothetical members are invested in a traditional 60/40 portfolio, although we acknowledge that the asset allocation could differ significantly for these members given their ages.

Exhibit 4 illustrates the projected account balance at age 65 for Member X (30 years away) and Member Y (10 years away), broken down by employee and employer contributions and investment returns. We also calculated the potential impact of excess returns of 1% above the assumed passive return target to demonstrate the potential value of active management.

Exhibit 4: Hypothetical projected account balances at age 65



Hypothetical example assumes beginning salary of $40,000 for Member X and $80,000 for Member Y and 2% annual wage growth. Member X assumed to save 4% of pay, Member Y assumed to save 10% of pay. Employer match assumed to be 100% of 4% of pay. Member Y assumed to have starting account balance of $250,000 at age 55. Average annual passive return of 6.1% over 30-year time horizon and 5.0% over 10-year time horizon based on a portfolio allocations of 40% global equity, 20% Canadian equity, 40% Canada Universe Bonds. Expected return assumptions based on MFS research and *MFS Long Term Capital Market Expectations* as at January 2024. Please refer to the appendix for more information on the methodology used for forward looking assumptions.

Over a 30-year time horizon, we estimate Member X will accumulate roughly $327,000 if returns meet the forward-looking assumption per year. In this example, an additional 1% of net excess return (*i.e.* a 7.1% average return over the period) results in a balance of approximately $388,000, a 19% increase in the account balance, a meaningful amount when considering a broad range of potential retirement outcomes.

Given the shorter time horizon until retirement for Member Y, we used a 10-year return assumption with an estimated 5% expected return for the 60/40 portfolio. Member Y's account is estimated to grow from the starting balance of $250,000 at age 55 to about $498,000 at age 65 if returns are 5% per year. An additional 1% of net excess return (*i.e.* a 6% return over the period) results in a balance of $543,000, which is 9% higher than our initial calculation.

Reality #2: While beta exposure alone may have supported members' retirement savings goals in the past, our *Long-Term Capital Market Expectations* suggests excess returns could be critical to helping keep members on track to achieve their retirement savings goals in the future.

Misconception #3: Sustainable investing is not aligned with fiduciary responsibility

Sustainable, or ESG (environmental, social and governance), investing is an important topic for DC plan fiduciaries. However, its prevalence and how it is implemented can vary significantly by country. Plan sponsors in Canada and the United States are generally in the early stages of incorporating sustainable investments into the plan menu, while sustainable investing is more mature and prevalent in the United Kingdom and Australia. Regulatory regimes in each country have been key drivers in supporting or discouraging the incorporation of sustainable investments in DC plans.

Despite varying regulations across the world, one voice that is consistently supportive of sustainable investing is that of the member. Survey results revealed 77% of Canadian plan members describe themselves as interested in seeing more ESG investments offered in their employer-sponsored retirement plans.

Exhibit 5: Member views on incorporating sustainable investments in DC plans

	Millennials (Ages 26–41)	Gen X (Ages 42–57)	Baby Boomer (ages 58–77)
Are interested in seeing **ESG** investments offered in their retirement plan	78%	75%	75%
Likely to **contribute at a higher rate** to the retirement plan if the plan offered investment options that consider ESG issues	72%	66%	64%
Prefer the funds they invest in within their retirement plan **NOT take E, S or G factors into consideration**	21%	29%	29%

Source: MFS 2023 DC Participant Survey Q1: How interested are you in seeing sustainable (ESG) investments offered in your employer-sponsored retirement plan? Percentages represent the sum of somewhat interested, very interested and extremely interested. Q2: How likely would you be to contribute at a higher rate to your workplace retirement fund if your plan offered or included investment options that consider sustainability issues? Percentages represent the sum of somewhat likely, very likely and extremely likely. Q3: Would you prefer the funds you invest in within your retirement plan to... See endnotes for more detail.

This member demand for sustainable or ESG-related investments is consistent with evolving consumer preferences, which are changing the way companies do business. Increasingly, employees want the companies they work for to be aligned with their values, and a growing cohort of consumers want the companies they do business with to share their values too. Given these trends, we expect that member demand for sustainable investments will continue to increase over time, which could offer plan sponsors a unique opportunity to communicate with members on a topic of interest to them.

Generally, there are two paths for plan sponsors to consider when incorporating sustainable investments into the DC plan — 1) the addition of ESG-themed funds to the investment menu or 2) a broader approach of integration in which ESG-related factors are considered during the fund selection and ongoing monitoring process.

One of the arguments for the notion that sustainable investing is incompatible with fiduciary responsibilities is based on the flawed premise that a member cannot enjoy superior returns while at the same time investing in funds that consider ESG factors. We believe that an integrated approach to sustainable investing, rooted in materiality, can potentially deliver on both returns and sustainability.

MFS' integrated approach considers material risks and opportunities — including ESG factors — part of the investment decision-making process. Ultimately, we believe asset owners will agree that sustainable investing is an important component of long-term active management, which in turn aligns with the long-term goals of investing for retirement.

MFS encourages plan fiduciaries to consider the following steps when contemplating the inclusion of ESG-related funds in the DC plan menu.

Educate the investment committee on ESG	Educate the committee on various approaches to responsible investing and provide answers to frequently asked questions; identify pertinent questions related to implementation
Develop a governance framework	Choose a path towards implementation that aligns with the organisation and employee goals
Update the IPS to reflect these beliefs	How will ESG principles be reflected in the statement of investment policies and procedures (SIPP) criteria for ongoing assessment?
Work with service providers to implement	Adopt ESG principles into RFP/due diligence process, reporting requirements and menu availability
Educate members	Incorporate chosen approach into member education and communication

Returning to the core fiduciary principles discussed earlier, we believe ESG integration will emerge as the most practical path forward for plan sponsors.

Reality #3: An integrated approach, such as the one employed by MFS, considers material risks and opportunities — including sustainability factors — part of the investment decision-making process and consistent with a plan fiduciary's responsibility.

In closing

We believe that investment returns in the next decade will be markedly lower than they have been historically, and skilled active management can play an important role in helping members achieve the additional returns needed to meet their retirement goals. Accordingly, we believe that following a prudent fiduciary process in the selection of actively managed strategies can greatly benefit plan members in achieving their retirement goals while also offering them an opportunity to access sustainable investments through an integrated approach.

Assumptions and methodologies

	Global Equities	Canadian Equities	Canadian Universe Bonds
10-Year Geometric Return (%)	4.3%	7.1%	4.2%
30-Year Geometric Return (%)	6.8%	6.7%	4.5%
Risk (%)	11.4%	12.8%	4.7%
Correlation			
Global Equities	1.00		
Canadian Equities	0.74	1.00	
Canadian Universe Bonds	0.36	0.20	1.00

Source: MFS research and *MFS Long Term Capital Market Expectations*, as of January 2024. Forward-looking expectations are annualised geometric total return and risk for a 10- and 30-year time horizon. Risk is defined as annualised monthly standard deviation. Equity forecasts are unhedged in CAD. References to future expected returns and performance are not promises or estimates of the actual performance realised by an investor and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation or be guarantees of performance. The forecasts are based on subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions but instead on the models and data compiled by MFS. The results do not represent or indicate actual results that may be achieved in the future. Individual investor performance may vary significantly.

Endnotes

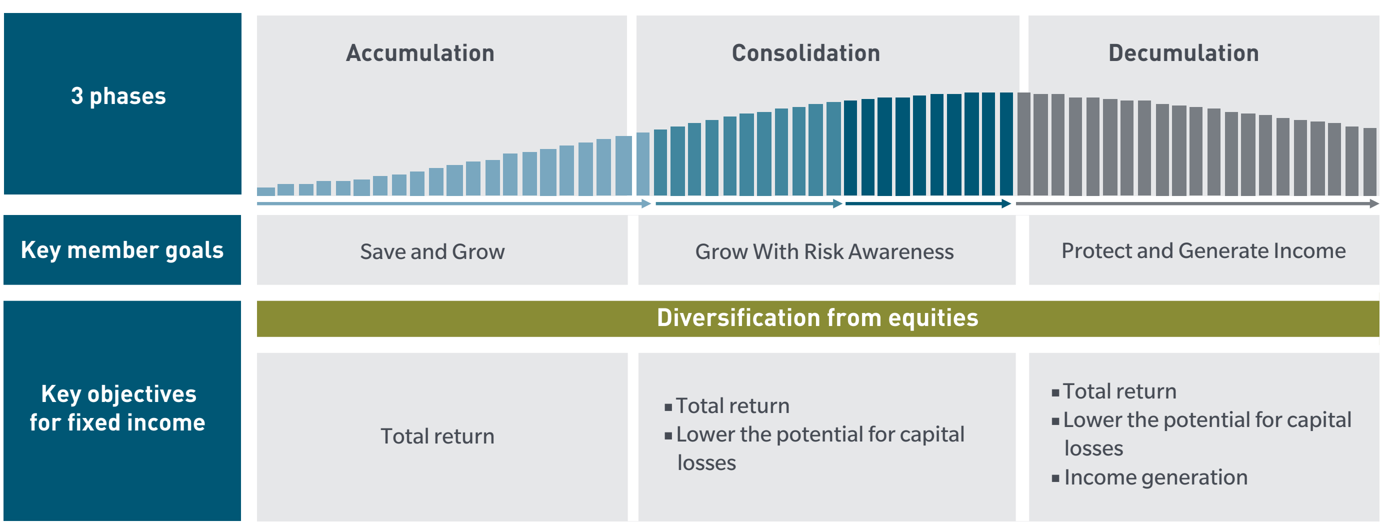
[1] Prudent Person principles hold that the standard of care that should be applied by fiduciaries when making investment decisions. While they may differ across regions, these principles generally suggest that a fiduciary should act with the care, skill and diligence that a prudent person would employ under similar circumstances.

[2] Dynata, an independent third-party research provider, conducted a study among Defined Contribution (DC) plan members in the US, UK, Canada and Australia on behalf of MFS.

MFS was not identified as the sponsor of the study. To qualify for participation in each region: US, actively contributing to a 401(k), 403(b), 457, or 401(a)/Canada, actively contributing to DC Pension Plan, Group Registered Retirement Savings Plan, Deferred Profit Sharing Plan, Non-Registered Group Savings Plan, or Simplified Employee Pension Plan/UK, actively contributing to a Defined Contribution Scheme, Master Trust, or Individual Savings Account/Australia, actively contributing to an industry, retail, corporate or public sector super fund or a self-managed super fund. The survey was fielded March 22 to April 6, 2023. There were 1,000 US respondents, 1,004 Canadian respondents, 1,003 UK respondents, and 1,000 Australian respondents.

[3] The Retirement Savings Journey, as depicted below.

The retirement savings journey



For illustrative purposes only.