

Q&A: REDESIGNING YOUR PLAN'S CORE MENU



FREQUENTLY ASKED QUESTIONS

In the paper, “Core: What is it good for?” we made the case for a streamlined menu that utilizes multi-manager, white label funds, and outlined the three steps you can take to get there. Now, let’s answer some of the frequently asked questions. We feel strongly, based on our decades-long experience of working with investment committees, that this approach builds a more solid core menu. Ultimately, we believe that it not only benefits plan participants striving to meet their retirement goals, but also investment committees working to fulfill their fiduciary responsibilities.

Exhibit 1: Participant plan menu tiers

Do it **FOR** me



TIER 1

60-80% of participants

Do it **WITH** me



TIER 2

20-30% of participants

Do it **MYSELF**



TIER 3

2-5% of participants

The chart above illustrates Russell Investments’ estimate of the percentage of participants that fall into each plan menu tier.

Q1: Why offer a tier of asset class options at all? Why not offer a plan design that consists solely of target date funds and a brokerage window?

A: Some investment committees are convinced that there are “do it for me” and “do it myself” participants in their plans but aren’t so sure that “do it with me” participants really exist. In some plans, that may be true; in those cases, a committee could follow this approach. However, for most plans, we think such a design may be too radical for investment committees

to implement and for plan participants to understand. If the plan is to be successful, any structure you pick needs to be embraced by both internal stakeholders and plan participants. So even though there may be limited “do it with me” participants in a plan, causing limited use of the core menu, other participants like to know there is choice, should they later want to exercise it. For investment committees thinking about a two-tiered approach but not quite ready to go there, a good first step is to at least de-emphasize the core menu by streamlining it, and then nudging participants toward the Qualified Default Investment Alternative (QDIA) in Tier 1 through a re-enrollment initiative.

Q2: Why offer as many as six to 12 options on a core menu? Aren't two or three enough?

A: In fact, there is a case for further “collapsing” the menu. Why separate U.S. small cap from U.S. large cap equity? Why separate U.S. and non-U.S. equity? How about offering one big global equity portfolio? There is certainly a compelling case for this type of menu, and many defined benefit plans have implemented this type of global equity framework. However, we haven’t known many defined contribution (DC) investment committees to offer this type of limited menu, so it’s hard to gauge how participants might react. As a result, most committees attempt to strike a balance between providing sufficient choice to accommodate a majority of participants and not overcomplicating investment decisions.

The menu design depends on what levers you want to provide to participants to adjust their portfolios. At the simplest level, the core menu gives participants the ability to adjust their portfolios between capital appreciation and preservation, which is based on their risk tolerance. If that’s the only lever you want to provide, then offering two or three broad options may make sense. But if you want to give participants the increased ability to make adjustments – in U.S. equity versus non-U.S., large cap versus small, active management vs. passive, to name a few – then you’d need to offer a wider range of options.

Our sample core menu is just one potential answer that we think is a good starting point for a committee discussion on the right number of options for your plan’s core menu.

Exhibit 2: Example of a Tier 2 menu

TIER 2—PASSIVE	TIER 2—ACTIVE
International Equity	International Equity
U.S. Small Cap Equity	U.S. Small Cap Equity
U.S. Large Cap Equity	U.S. Large Cap Equity
Core Fixed Income	Core/Plus Fixed Income
	Capital Preservation

Q3: I have more than 20 options available today. Collapsing that menu down to six options seems drastic. What should I do?

A: There is no magic number. However, we believe that a more streamlined menu will simplify participant decisions, increase engagement and ultimately drive better retirement outcomes. The best place to start is to look for opportunities where you can reduce overlap between options. For example, how many U.S. options do you have versus non-U.S.? Do you need three style funds each in U.S. small cap and mid cap? Make sure your plan lineup seems balanced across the risk and reward spectrum. Reducing options can feel like a “take-away,” but we find that many participants react well to a streamlined menu and appreciate the more manageable decision-making process. We encourage investment committees to focus on the majority of participants that will benefit from a simplified menu, not just the minority that voice opposition to fund changes. For those who want the extra choice, the brokerage window is always an option in those plans that offer one.

Q4: You suggested using the asset-class names for the white-labeling. But do participants really understand what these names mean?

A: We agree that some percentage of your participant population might not understand asset-class names. Hopefully, these participants will acknowledge that they are “do it for me” investors and select that appropriate Tier 1 menu option. Beyond that, we’ve heard interesting ideas for alternative naming conventions, but we haven’t seen them tested. Some have suggested including more descriptive terms, to indicate the objective of the fund – (e.g., “conservative,” “growth,” “inflation protection”). But these terms can be ambiguous and somewhat ill-defined, and they often mean different things to different people. What happens when your inflation-protection fund drops significantly, like in 2008 when the S&P GSCI Commodity Index lost 46.5%? What happens when interest rates rise and your conservative fund then has negative performance? Might more descriptive names encourage unrealistic expectations? Asset-class names are more conventional and more readily defined, for most participants and for plan committees as well. So, we use asset class names as our starting point.

Q5: Do I need to implement all three steps at the same time?

A: Not necessarily. These steps are not mutually exclusive. We think it's most powerful if you implement all three at once, but you could implement the pieces over time. You could simply streamline the menu. Or, you could white-label single-manager funds. Or, you could offer a multi-manager fund but continue to use the multi-manager brand name. All of these things are good steps in moving toward a more understandable solution for participants. We do find that some committees and participants are more comfortable when changes are introduced incrementally. You can start by "test driving" some of the solutions with a part of your lineup. For example, U.S. small cap equity is an area where plans tend to offer multiple funds. It's often hard to find just one high-quality U.S. small cap equity manager, due to concerns about a single manager's capacity constraints, style drift and cap drift. So, offering a single white-labeled multi-manager U.S. small cap solution may be a good place to start. However, using an approach that implements changes over time should be balanced with managing transaction costs and potentially overwhelming participants with notices regarding another menu update.

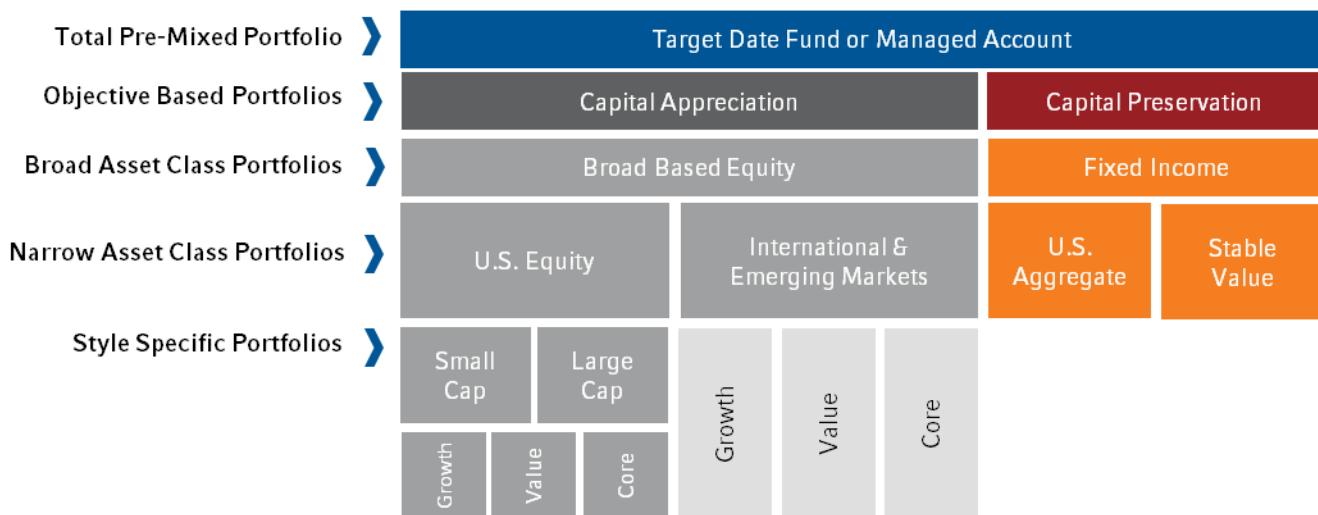
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Q6: What about active and passive investing tiers? Should I offer both in my plan?

A: Including both an active and a passive investing tier in a DC plan, in an effort to accommodate the needs of a majority of employees, is a reasonable approach. However, the distinction between the tiers should be communicated so as not to overwhelm participants with too many highly correlated investment choices. We believe that this can be accomplished with an active and passive mirrored structure, represented by key asset classes. Our baseline structure for the core menu is outlined in Exhibit 3.

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Exhibit 3: Baseline structure for core menu



Q7: From an operational standpoint, isn't moving to a white-labeled and/or multi-manager structure a headache?

A: It certainly can feel easier to simply pick the XYZ Mutual Fund and be done. But is that the best fiduciary and participant solution? Moving to a white-labeled and/or multi-manager approach does involve additional considerations and work. The white-labeling component is usually the easy part. Getting everything set up with the record keeper requires some work, but our experience has been that all record keepers capable of supporting mid to large plans are now able to accommodate white-label funds.

Building custom multi-manager funds can involve more work with your record keeper and custodian. As an investment committee who is building your own multi-manager funds, you will need to think beyond just picking the managers and determining the allocations. Additional considerations include establishing a liquidity account, rebalancing, and conducting smart cash flow management and effective transition management. However, these aren't new issues for institutional-size DC plans, and there are plenty of record keepers and custodians who know how to support these structures. Your consultant should also be able to provide guidance throughout the process.

Plans that don't have the scale required to handle some of the fixed administrative costs that come with this approach, or that don't have the internal expertise to execute the move themselves, may want to consider outsourcing the solution to providers who can implement custom or off-the-shelf multi-manager options.

Q8: With more custom solutions, aren't participant communications more difficult?

A: As with all custom solutions, this approach does introduce some different communications challenges. But they are not new challenges, and we think the extra effort is worthwhile, given the potential benefits to participants. Record keepers have developed communication strategies to fully support these custom solutions. If your plan is implementing an off-the-shelf multi-manager structure, the provider should already have all the necessary participant communication materials your plan will need.

Q9: Wow, this sounds like a lot more fiduciary risk. Isn't it less of a risk to pick an off-the-shelf mutual fund?

A: Remember, there is no "easy button" when it comes to meeting fiduciary responsibilities. Just ask any investment committee that has recently been involved in fiduciary litigation; many of them used retail mutual funds¹. While it seems that a custom approach is more work, or that the investment committee is taking on a greater fiduciary burden, just allowing a mutual fund provider to make all the decisions for your plan is no less risky. We believe you will be on solid ground as long as you do what you believe is in the best interests of participants, document your decisions, follow the prudent investor standard and engage the services of experts when you don't have the requisite expertise.

Q10: How do I report performance on these types of solutions?

A: There are a few ways to approach this. Depending on whether you set up a custom or an off-the-shelf solution, the historical performance record that you can show may be different. The nice thing about these approaches is that once the fund is live, it will build its own performance stream. Participants will see the performance of the overall option, which will continue even as underlying managers are swapped in and out. The committee, (if you are building a custom solution), or the multi-manager provider, (in the case of an off-the-shelf fund), will monitor the performance of the underlying managers to see if they are meeting expectations.

Plans that don't have the scale required to handle some of the fixed administrative costs that come with this approach, or that don't have the internal expertise to execute the move themselves, may want to consider outsourcing the solution to providers who can implement custom or off-the-shelf multi-manager options.

¹ Barry, M. (2012) "Tussey v. ABB" Plan Advisory Services. Retrievable at <http://www.planadvisoryservices.com/public/features/tusseyabb.html>

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