



September 2024

NATIONAL ABLE ALLIANCE

2024 Investment Changes Recommendation

National ABLI Alliance

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Executive Summary

The National ABLI Alliance (“NAA”) Investment Policy Subcommittee (“IPSC”), led by the Office of the Illinois State Treasurer (“ILSTO”), reviewed the results from annual benchmark, fee, and asset allocation studies conducted by Marquette, ILSTO external investment consultant, and Ascensus, NAA’s program manager and investment advisor, to assess investment changes to be recommended to the NAA.

After thorough analysis by all parties, the NAA IPSC agreed on a few asset allocation changes to the Target Risk Options in response to forward looking capital market assumptions for fixed income, as well as determined that two manager searches were to be conducted. The manager searches consisted of the following: 1) a single total market equity index fund to replace the program’s two existing domestic equity funds and 2) an interest-bearing standalone investment option.

The first search was performed with the intention to replace the two current allocations to domestic equities, the Vanguard Institutional Index Fund (VIXX) and the Vanguard Extended Market Index Fund (VEMPX), within the Target Risk Options, with one equity index strategy. This was done as a way to align the NAA’s investment line-up market capitalization exposure to domestic equities, to that of the domestic equity universe.

The second search was performed with the intention to add a low-risk 8th investment option, that was interest-bearing, to the NAA investment line-up. This was viewed as a prudent decision given that approximately 27% of NAA assets have historically been invested in the Checking Option, which generates a yield of 0.01%. As a majority of these assets are not used for transactional purposes, we believed that account owners would benefit from earning a higher yield on a similarly low-risk investment option.

Through the due diligence process for this search, the investment rationale and conviction for the Sallie Mae bank savings product within the Moderately Conservative and Conservation Target Risk Options as the appropriate cash allocation was reassessed and determined to have weakened. As a result, the IPSC made an additional recommendation to adjust the cash allocation within the Target Risk Options by removing the Sallie Mae savings product with the Vanguard Cash Reserves Federal Money Market Fund.

Therefore, subsequent to comprehensive quantitative and qualitative analyses performed, as well as interviews with the senior leadership and portfolio management teams of each prospective fund for the manager searches, the NAA IPSC recommends the following:

1. **Adjusting the allocations within the Target Risk Options by:**
 - a. **Replacing the two current domestic equity index allocations within all of the Target Risk Options with the Vanguard Total Stock Market Index Fund (VSMXX);**
 - b. **Adding the American Funds High Income Fund (HIGFX) to the Moderate and Growth Target Risk Options;**
 - c. **Decreasing the exposure to the Vanguard Short-Term Inflation-Protected Securities Index Fund (VTSPX) across all six Target Risk Options by increasing the exposure to the Vanguard Total Bond Market Index Fund (VBIMX) and the Vanguard Short-Term Bond Market Index Fund (VBIPX); and**

- d. **Replacing the Sallie Mae high yield bank savings product within the Moderately Conservative and Conservative Target Risk Option with the Vanguard Cash Reserves Federal Money Market Fund (VMRXX).**
2. **Adding the Vanguard Cash Reserves Federal Money Market Fund (VMRXX) as a standalone 8th investment option.**

Decision Making Process

After reviewing the results from the annual benchmark, fee, and asset allocation studies conducted by Marquette and Ascensus, as well as the ILSTO's internal analysis, the NAA IPSC determined that the allocation tweaks to the fixed income sleeves of the Target Risk Options should be changed in order to decrease the allocation to TIPS and increase the portfolio's exposure to duration by approximately one year to account for a normalizing inflationary and interest rate environment. Additionally, the NAA IPSC determined that the two manager searches as noted above should be conducted. After discussions with the wider National ABLE Alliance regarding these changes, the ILSTO requested Marquette and Ascensus both conduct independent investment searches to provide candidates for both searches. The ILSTO also conducted an independent assessment of both searches. After receiving all search materials, the NAA IPSC selected finalists for interviews.

Total Market Equity Index Search

The NAA IPSC, together with representatives from Marquette (ILSTO external investment consultant) and Ascensus (NAA program manager and investment advisor), narrowed the manager search to interview the following finalists for evaluation:

- Vanguard Total Stock Market Index Fund (VSMPX)
- Fidelity Total Market Index Fund (FSKAX)
- iShares Total US Stock Index Fund (BKT SX)

As a result of the due diligence processes the Vanguard Total Stock Market Index Fund (VSMPX) is recommended for the NAA's allocation to domestic equities within the Target Risk Options for the following reasons:

- ***Price:*** VSMPX's 2bps fee is well-below category averages.
- ***Effective portfolio construction:*** Vanguard's long history of index tracking has allowed the fund to achieve its stated objective of tracking index performance by minimizing tracking error.
- ***Supplemental alpha generation:*** Vanguard's use of securities lending and its related reinvestment into the Fund has generated incremental alpha for the fund over its benchmark.
- ***Stable fund management and structure:*** The VSMPX portfolio management team is well-tenured and has remained with the firm for extensive lengths of time.
- ***Benchmark Selection:*** The Fund is benchmarked against the CRSP US Total Market Index, which encompasses the entirety of the US equity market capitalization across large, mid-, and small-cap equities.
- ***Firm-wide support and partnership:*** Vanguard is one of the largest and most established asset managers for passively managed products, which enables the VSMPX team to leverage best-in-class resources and offer a compelling fee.

Interest-Bearing Standalone Investment Option Search

The NAA IPSC, together with representatives from Marquette (ILSTO external investment consultant) and Ascensus (NAA program manager and investment advisor), narrowed the manager search to interview the following finalists for evaluation:

- Sallie Mae High Yield Savings Account (FDIC Insured)
- Vanguard Federal Money Market Fund (VMFXX)
- Vanguard Cash Reserves Federal Money Market Fund Admiral Shares (VMRXX)
- State Street Institutional US Government Money Market Fund (CAHXX)
- Invesco Government & Agency Portfolio (AGPXX)

As a result of the due diligence processes the Vanguard Cash Reserves Federal Money Market Fund Admiral Shares (VMRXX) is recommended for the NAA's consideration of an 8th investment option for the following reasons:

- *Price:* VMRXX's 10bps fee is well-below category averages and the lowest amongst finalists.
- *Yield:* VMRXX's investment process draws on Vanguard's robust resources, including its deep bench of credit analysts and traders, to generate the highest quality yields amongst peers.
- *Stable fund management and structure:* The VMRXX portfolio management team is well-tenured and has remained with the firm for extensive lengths of time.
- *Firm-wide support and partnership:* Vanguard is one of the largest and most established asset managers in the cash management and liquidity space, which enables the VMRXX team to leverage best-in-class resources and offer a compelling fee.

Replacement of Sallie Mae within Target Risk Options

Through the diligence process for the interest-bearing standalone investment option manager search, conviction in the cash allocation to Sallie Mae's high-yield bank savings product within the Moderately Conservative and Conservation Target Risk options was weakened. This was as a result of various factors:

- *Yield Setting Process & Transparency:* Due to the nature of bank savings products, the type of yield offered on the product is competitive with internet banking peers, but is not required to be benchmarked to a specific rate, such as the Federal Funds Effective Rate. Specifically for Sallie Mae, the rate provided for its product is determined by a pricing committee. This structure limits the transparency into how the rate is determined and imposes ambiguity into the pace of subsequent rate changes. This is particularly relevant when compared to government money market funds which target yielding the Federal Funds Effective Rate on a daily basis.
- *Collateral Quality:* For the Sallie Mae bank savings product, the underlying collateral that facilitates the product are private student loans. These loans are not backed by the U.S. government, and are subject to significant interest rate risk due to the long-term (10-year) nature of the loans. Alternatively, money market funds are invested in the highest quality Treasury and agency securities that have limited interest rate risk due to the constraints on weighted average maturity (less than 60 days) and weighted average lives (less than 120 days) for underlying investments in a money market fund.
- *Limited Peer Interest:* In going through the standalone investment option search, we reached out to various peer high yield bank savings product providers. One provider did not want to go through the search due to balance sheet management constraints and a separate provider's product was closed to new entrants. This disinterest and apparent shrinking of the universe of compelling institutional bank savings products was evidence of further concern with bank savings products more broadly.

- *Firm's Credit Profile:* Sallie Mae's creditworthiness is considered a below-investment grade / junk bond investment based on ratings from Moody's, S&P, and Fitch. For a desired safe and simple cash allocation, we view this as potential headline risk to the Target Risk Options.

With these factors in mind and as a result of our higher conviction in money market products more broadly, and specifically lower conviction in the Sallie Mae product, we recommend replacing the Sallie Mae High Yield Savings product with the Vanguard Cash Reserves Federal Money Market Fund (VMRXX) within the Target Risk Options.

We acknowledge that with this change, the weighted fee changes of the Moderately Conservative and Conservative Target Risk Options will increase, by 2bps and 6 bps respectively, to be priced at 31bps and 34bps inclusive of program management fees. We view this increase in fees as commensurate with a higher quality investment product with higher transparency on yields, which was the primary intention of the standalone investment option. Additionally, these Target Risk Options still remain fee competitive within the ABLE industry.

Recommendation

After thorough diligence procedures for the two manager searches as noted above, and the initial considerations related to allocation changes for the Target Risk Options to adjust for forward looking risk and return assumptions, the NAA IPSC formally recommends:

- 1. Adjusting the allocations within the Target Risk Options by:**
 - a. Replacing the two current domestic equity index allocations within all of the Target Risk Options with the Vanguard Total Stock Market Index Fund (VSMPX);**
 - b. Adding the American Funds High Income Fund (HIGFX) to the Moderate and Growth Target Risk Options;**
 - c. Decreasing the exposure to the Vanguard Short-Term Inflation-Protected Securities Index Fund (VTSPX) across all six Target Risk Options by increasing the exposure to the Vanguard Total Bond Market Index Fund (VBMPX) and the Vanguard Short-Term Bond Market Index Fund (VBIPX); and**
 - d. Replacing the Sallie Mae high yield bank savings product within the Moderately Conservative and Conservative Target Risk Option with the Vanguard Cash Reserves Federal Money Market Fund (VMRXX).**
- 2. Adding the Vanguard Cash Reserves Federal Money Market Fund (VMRXX) as a standalone 8th investment option.**

Marquette, ILSTO external investment consultant, is in alignment with all recommendations as noted above. Particularly related to the replacement of the Sallie Mae bank savings product, Marquette traditionally does not use bank savings products with other institutional clients and recommends money market funds instead as a higher quality safe cash-like investment option. As such, Marquette did not include bank savings products in their standalone investment option search materials entirely.

Ascensus, NAA program manager and investment advisor, is in alignment with all the investment recommendations above, except for the replacement of the Sallie Mae high yield bank savings product within the Target Risk Options. This is due to concerns related to the fee increases of the Moderately Conservative and Conservative Target Risk Options if the Sallie Mae product were to be removed. However, Ascensus has noted they can operationally handle all recommendations.

Refer below to the implications of the recommendations on asset allocation and fee changes within the Target Risk Options.

Current Lineup with Current Allocations

Underlying Investment Product	Ticker of Underlying Product	Expense	Investment Portfolio Options					
			Aggressive	Moderately Aggressive	Growth	Moderate	Moderately Conservative	Conservative
Vanguard Institutional Index Fund – Institutional Plus	VIII	0.02%	28.00%	22.00%	18.00%	13.00%	9.00%	3.00%
Vanguard Extended Market Index Fund – Instl Plus Shares	VEMPX	0.04%	23.00%	20.00%	16.00%	12.00%	8.00%	3.00%
Vanguard Developed Market Index Instl	VTMNX	0.06%	22.00%	18.00%	15.00%	11.00%	7.00%	2.00%
Vanguard Emerging Markets Stock Index Instl	VEMX	0.10%	9.00%	8.00%	6.00%	5.00%	3.00%	1.00%
Schwab U.S. REIT ETF	SCHH	0.07%	8.00%	7.00%	5.00%	4.00%	3.00%	1.00%
Vanguard Total Bond Market Index Fund – Institutional Plus Shares	VBMPX	0.03%	4.00%	10.50%	12.00%	16.50%	13.50%	9.00%
Vanguard Short-Term Bond Index Fund – Institutional Plus Shares	VBIPX	0.04%	0.00%	3.25%	10.00%	13.75%	11.25%	7.50%
Vanguard Short-Term Inflation-Protected Securities Index Fund – Institutional Shares	VTSPX	0.04%	2.00%	5.75%	14.00%	19.25%	15.75%	10.50%
American Funds High Income F3	HIGFX	0.32%	3.00%	3.00%	0.00%	0.00%	0.00%	0.00%
iShares® Core International Aggregate Bond ETF	IAGG	0.07%	1.00%	2.50%	4.00%	5.50%	4.50%	3.00%
Sallie Mae High Yield FDIC		0.00%	0.00%	0.00%	0.00%	0.00%	25.00%	60.00%
	Underlying Expense		0.05%	0.05%	0.04%	0.04%	0.03%	0.02%
	Program Management Fee		0.26%	0.26%	0.26%	0.26%	0.26%	0.26%
	Total Portfolio Cost		0.31%	0.31%	0.30%	0.30%	0.29%	0.28%

Recommended lineup 2024

Underlying Investment Product	Ticker of Underlying Product	Expense	Investment Portfolio Options					
			Aggressive	Moderately Aggressive	Growth	Moderate	Moderately Conservative	Conservative
Vanguard Total Stock Market Index Instl Plus	VSPMX	0.02%	51.0000%	42.0000%	34.0000%	25.0000%	17.0000%	6.0000%
Schwab U.S. REIT ETF	SCHH	0.07%	8.0000%	7.0000%	5.0000%	4.0000%	3.0000%	1.0000%
Vanguard Developed Market Index Instl	VTMNX	0.06%	22.0000%	18.0000%	15.0000%	11.0000%	7.0000%	2.0000%
Vanguard Emerging Markets Stock Index Instl	VEMX	0.10%	9.0000%	8.0000%	6.0000%	5.0000%	3.0000%	1.0000%
Vanguard Total Bond Market Index Fund – Institutional Plus Shares	VBMPX	0.03%	5.0000%	13.7500%	24.0000%	33.0000%	27.0000%	18.0000%
Vanguard Short-Term Bond Index Fund – Institutional Plus Shares	VBIPX	0.04%	0.5000%	2.5000%	4.0000%	6.8750%	6.7500%	4.5000%
Vanguard Short-Term Inflation-Protected Securities Index Fund – Institutional Shares	VTSPX	0.04%	0.5000%	2.5000%	4.0000%	6.8750%	6.7500%	4.5000%
American Funds High Income F3	HIGFX	0.32%	3.0000%	3.7500%	4.0000%	2.7500%	0.0000%	0.0000%
iShares® Core International Aggregate Bond ETF	IAGG	0.07%	1.0000%	2.5000%	4.0000%	5.5000%	4.5000%	3.0000%
Vanguard Cash Reserve Federal Money Market Admiral	VMRXX	0.10%	0.0000%	0.0000%	0.0000%	0.0000%	25.0000%	60.0000%
Changes in Yellow	Underlying Expense		0.05%	0.05%	0.05%	0.05%	0.05%	0.08%
	Program Management Fee		0.26%	0.26%	0.26%	0.26%	0.26%	0.26%
	Total Portfolio Cost		0.31%	0.31%	0.31%	0.31%	0.31%	0.34%
	Change in Total Portfolio Costs		0.00%	0.00%	0.01%	0.00%	0.02%	0.06%

Source: Ascensus