The Rise of Target Date Funds

The simplicity that target date funds bring to the plan participant investment decision-making process stands in sharp contrast to the complicated evaluation that plan fiduciaries must undertake in the selection process. When selecting a target date fund, there is no “right” or “wrong” answer for every plan—but there is likely “an appropriate fit” for your plan.

This paper will explore the issues that plan fiduciaries will need to consider when adding or re-evaluating target date funds for their defined contribution plans.

The growth of target date funds (TDFs) in employer-sponsored defined contribution plans has been nothing short of extraordinary. In the last five years, TDF assets have increased four-fold, from $115 billion in the first quarter of 2009 to $462 billion in the second quarter of 2014.

The catalyst for this development was the passage of the Pension Protection Act of 2006, which included a directive to the Department of Labor (DOL) to formulate a framework for the selection of default investments in participant-directed plans, otherwise known as a qualified default investment alternative, or QDIA.

While some plan sponsors chose a balanced fund or principal preservation QDIA, most elected to use a TDF (or lifestyle fund), considered an “approved” QDIA by the DOL. According to Towers Watson, TDFs are the QDIA for 86% of all defined contribution plans in 2014, up from 64% in 2009.

While federal legislation may have set the stage for TDFs’ dominance in defined contribution plans, their exceptional popularity would not be conceivable if they didn’t offer compelling benefits to plan participants and sponsors alike.

For plan sponsors, TDFs represent an effective way to help employees potentially achieve better retirement outcomes, and therefore, offering a TDF may lead to higher participation rates.

For plan participants, TDFs can offer a number of important advantages. They are a convenient way to invest in a fully diversified portfolio suitable to an individual’s approximate date of retirement, offering participants a means to diversify their assets over multiple markets with a precision they could not likely achieve on their own.

The U.S. Department of Labor (DOL) prepared general guidance to assist plan fiduciaries in selecting and monitoring TDFs and other investment options in 401(k) and similar participant-directed individual account plans. The guidance, titled “Target Date Funds - Tips for ERISA Plan Fiduciaries”, sets forth the following important reminders for plan fiduciaries:

• Establish a process for comparing and selecting TDFs
• Establish a process for periodic review of selected TDFs
• Understand the fund’s investments – the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time
• Review the funds fees and investment expenses
• Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan
• Develop effective employee communications
• Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection
• Document the process

We encourage you to read the full DOL guidance for more information.
In addition to their diversification benefit, TDFs also offer features that may help individuals avoid some common investment mistakes, such as very aggressive or too conservative allocations, and ill-advised market timing. TDFs are managed with a disciplined, long-term approach, are automatically rebalanced to keep allocations intact, and are adjusted over time to account for the changing risk profile of an aging investor.

**The Anatomy of a Target Date Fund**

Though TDFs may simplify the investment decision for plan participants, they represent a much greater challenge for plan fiduciaries when evaluating and selecting them as plan investment options. Some plan sponsors have mistakenly assumed that any fund with the same date in its title (say, a “2020” fund or a “2050” fund) must be relatively similar to its peers. However, this is not the case. The unique complexity of TDFs may leave many plan fiduciaries uncertain about the characteristics that need to be evaluated and the choices they need to consider.

It’s critical to appreciate that there is no “right” answer or “wrong” answer. The appropriate answer will be the TDF that most suitably balances the plan’s goals and the needs of a diverse workforce.

**Define Your Goals**

The journey to selecting an appropriate TDF investment option begins with defining the plan’s goals. These goals can be formulated by answering several key questions.

*Answering some questions may point toward a “to” or “through” glide path…*

What is the historical behavior of participants with regards to withdrawing plan assets? Have they tended to keep assets in the plan even after retirement, or do they tend to withdraw them upon reaching retirement, perhaps to roll them over into a personal Individual Retirement Account (IRA)?

*while other questions may help define a suitable investment approach*

- How investment savvy are the participants? How do they define the terms “aggressive” or “conservative?”
- What is the investing pattern of plan participants? Is the plan account likely to be the major or only retirement asset of plan participants other than Social Security, or will they have additional resources upon which to rely, either in the form of personal savings investments or other employer-based retirement benefits?
- How much asset class and investment family diversification does a plan sponsor desire in a TDF?
- What are the plan’s return and volatility expectations?

The answers to these questions can help plan sponsors narrow down the universe of TDFs to a more manageable set of funds to better identify those with the structure and investment approach best aligned with the needs of the plan and its participants.

**Understanding the Asset Allocation Strategy**

There are many ways to construct an asset allocation. Knowing a TDF’s approach is crucial for plan fiduciaries in understanding the risk/reward profile of a particular fund. For example, the goal of capturing the highest long-term absolute returns will result in a different allocation than one looking to earn attractive risk-adjusted returns.

Systematic rebalancing of a TDF’s portfolio is essential to maintaining its integrity. Consequently, it’s important to be aware of how a manager will execute on this rebalancing strategy. Is it mechanistic, or is the manager provided with a degree of discretion? Is the manager empowered to exercise tactical asset allocation?

While the asset allocation decision may be one of the most significant determinant of the fund’s performance, how a manager executes that strategy through the investments it makes should not be overlooked.
Investing is as much art as it is science, so a plan fiduciary should have a level of trust in the manager’s investment process and his or her judgment. Two key execution considerations are whether the underlying investment approach is active or passive and if the fund’s component strategies are managed by a single manager or by multiple money managers who are particularly skilled in the specific asset class they are managing.

**Glide Path: To or Through?**

The glide path refers to the TDF’s method for changing the fund’s allocation over time. For instance, a 2040 TDF may begin with an allocation of 90% equity and 10% bonds, but as time goes on that allocation may change incrementally to reduce the equity exposure and increase the bond holdings until, upon reaching the target maturity date of 2040, its allocation may be 60% bonds and 40% equity.

The glide path comes in two basic forms: “To retirement” and “Through retirement.”

In the case of “to retirement,” the fund’s asset allocation will become fixed at the fund’s target maturity date. For example, if a 2040 TDF is structured to have an asset allocation at its target maturity date of 60% bonds and 40% equity, the fund’s allocation will remain essentially static once it reaches its target maturity date. In contrast, the “through retirement” glide path will continue to adjust the asset allocation (generally reducing equity exposure) for many years after reaching its target maturity date.

The “to retirement” glide path will generally assume a more conservative allocation as it approaches its target maturity date. Such funds are generally more focused on meeting retirement income needs and managing assets from market risk than achieving the highest possible pre-retirement balance.

The primary drawbacks to the “to retirement” glide path are that its lower equity exposure may sacrifice the potential for capital growth in the years leading up to retirement age precisely when assets may be at their highest levels, and offer only limited purchasing power protection during retirement.

However, the “to retirement” glide path may potentially offer greater protection against the sequence of returns risk—the risk that negative investment returns occur during the peak of wealth accumulation and/or early into the income withdrawal phase.

The “to retirement” glide path may be a better option for participants who will withdraw all their assets soon after retirement, want a steadier base of assets from which to draw income, or have other sources of savings to supplement retirement income.

The “through retirement” glide path will typically have a higher equity allocation for most of the life of a TDF, with the glide path extending up to 15-20 years beyond its target maturity date before it settles on its most conservative allocation.

While this glide path approach may subject the investor to increased exposure to the sequence of returns risk, it can potentially do a superior job of helping to protect against longevity risk, i.e., the risk of running out of money.

The “through retirement” glide path may be more appropriate for plan participants who want the potential for greater capital appreciation, even during their retirement years. This glide path may also be valuable to those individuals with insufficient savings capacity or assets since a more aggressive equity posture may lead to greater capital growth.

One approach is not necessarily better than the other. Indeed, even TDFs with the same glide path philosophy may be substantially different with regard to how their risk exposure is managed over time. Plan sponsors may find this challenging, but ultimately, the TDF landscape represents a considerable amount of choice, which has the benefit of giving plans the ability to better tailor a TDF investment option menu to their workforce demographic and plan objectives.
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Evaluating Performance

The three primary determinants of TDF performance are its asset allocation, glide path and individual investment decisions.

Plan sponsors should evaluate TDF performance based on the fund’s philosophy and design and whether it performed as intended. Performance attribution provides additional information on whether the portfolio manager is adding value through asset allocation and/or through its individual investment decisions.

Conclusion

It has been said that for every problem, there is a solution, and for every solution, there is a problem. Though TDFs may be a solution that confers benefits to plan participants and sponsors alike, they do not come without their own set of challenges.

The complex process of evaluating and selecting TDF investment options is not something that plan fiduciaries need to do on their own. Involving an outside investment professional can help plan fiduciaries navigate these complicated waters and reap the benefits of a TDF menu that most appropriately meets the plan’s needs and the retirement goals of plan participants.

1 http://www.dol.gov/ebsa/pdf/fsTDF.pdf

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