Advisors Selecting Target Date Funds Crave Legal Protection

- Advisors can protect themselves from lawsuits by choosing TDFs that protect beneficiaries from losses.
- Advisors are not choosing safe TDFs because they believe procedural prudence will protect them from lawsuits. They are copycats, choosing what everybody else chooses.
- Either approach might fail to protect. Being different or being reckless could get you into court.

Advisors have a couple of ways they can protect themselves from lawsuits when they select target funds. They can try to select the best fit to beneficiary needs and wants (known as substantive prudence), or they can copy what other advisors are doing (known as procedural prudence). Neither approach guarantees against lawsuits. We discuss your choices in the following so you can be the judge.

Substantive Prudence: Beneficiaries Want to be Safe, and Should Be. Consultants Agree

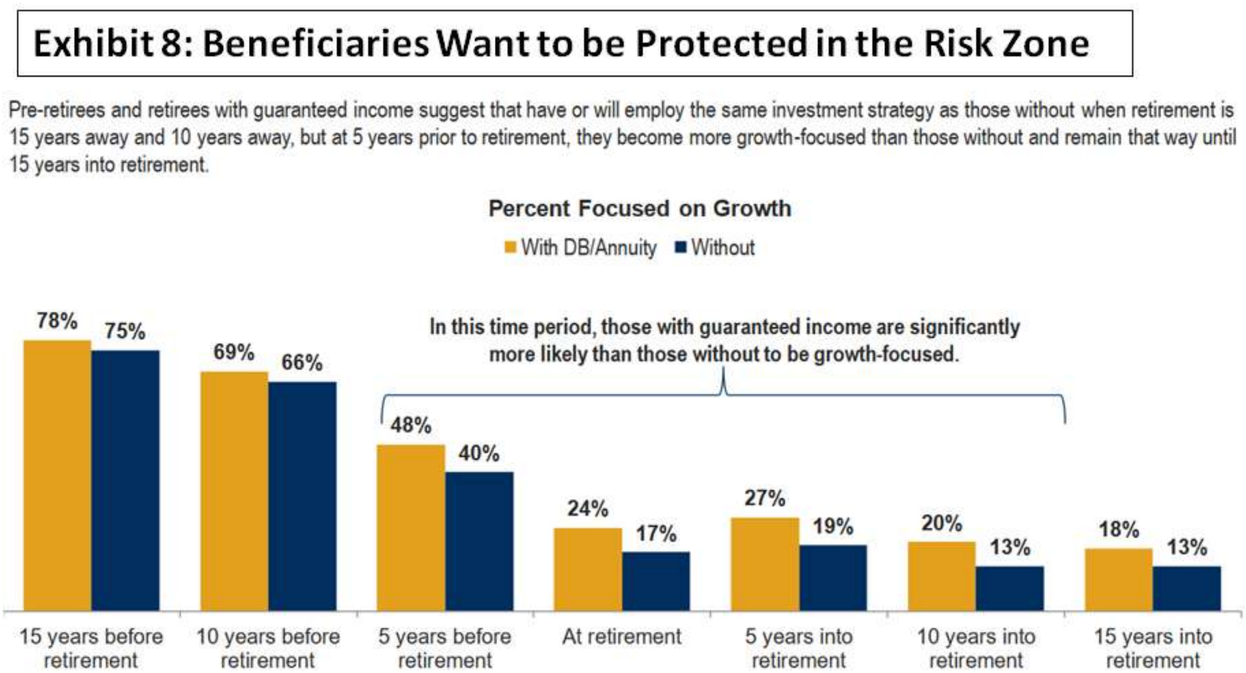
Most assets in TDFs are there by default, so the common demographic of all TDF beneficiaries is lack of financial sophistication. Financially sophisticated participants make their own investment choices. So what do these beneficiaries want?

A recent MassMutual Retirement Savings Risk Study examines beneficiary risk preferences in 401(k) plans. The methodology is as follows:

> *On behalf of MassMutual, Greenwald & Associates, an independent research firm, conducted an online survey that included 804 pre-retirees and 801 retirees. Respondents were drawn from ResearchNow's online panel. To qualify for the survey, all respondents had to be at least 40 years old.*
>
> *Pre-retirees were required to have a household income of at least $40,000, work full-time for a private sector employer, and be participating in that employer's DC retirement plan.*

↫Retirees were required to have total investable assets of at least $100,000. They had to be retired from a private sector employer and participating in that employer's DC retirement plan at the time of retirement.

One of the most informative tables in the report shows beneficiary preference for safety over growth in the "Risk Zone" that spans the ten years before and after retirement:



Source: Mass Mutual

At 15 years to the target date, the vast majority (75%) want growth over safety, but this preference shifts dramatically so that only 17% prefer growth over safety at retirement. Also shown in the graph, those with another source of income, like a DB plan, opt for somewhat more growth, obviously because their other assets are safe.

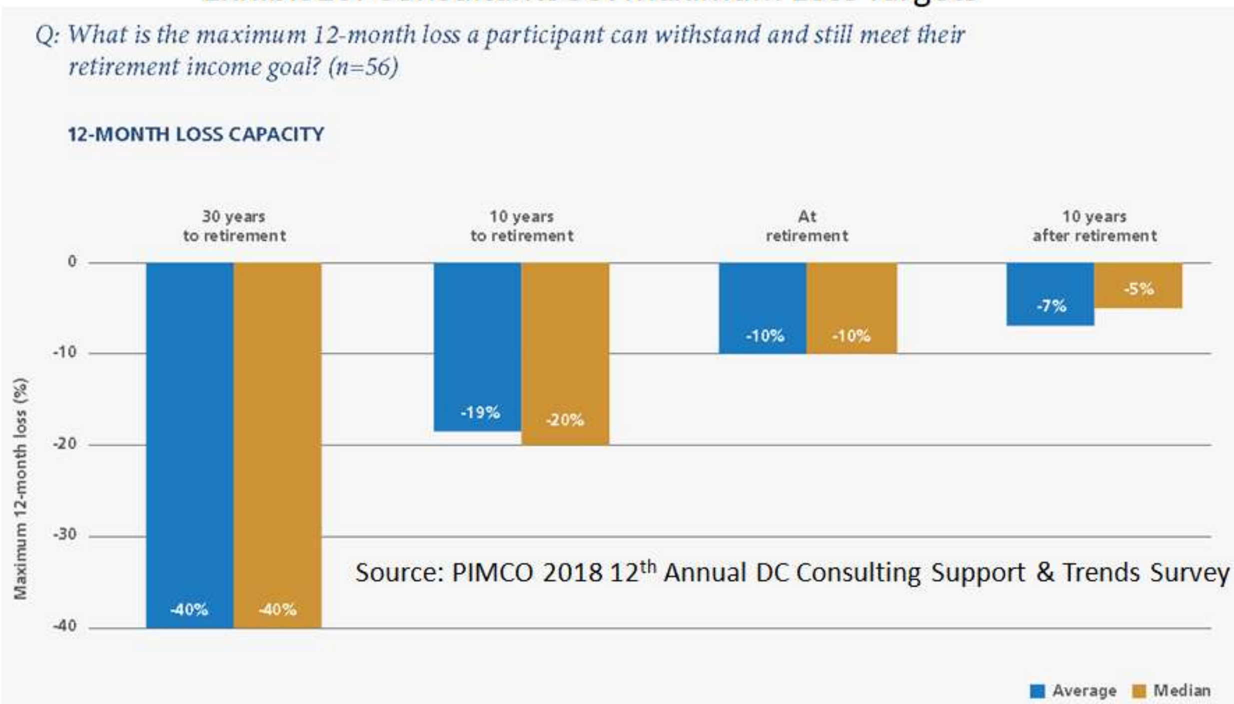
The preferences in the table above can be used as proxies for preferred equity allocations along the glide path. The following graph shows these preferences in contrast to the industry practice (Vanguard) and a substantive prudence index (SMART) .

Beneficiary preferences are in line with both Vanguard and SMART when beneficiaries are young but they move to the SMART index near retirement. In retirement, beneficiary preferences are more conservative than both.

Consultants agree. Pacific Investment Management Company (PIMCO) conducted another survey entitled the "2018 12th Annual DC Consulting Support & Trends Survey", which they describe as follows: *Our 2018 survey captures data, trends and opinions from 77 consulting firms across the U.S., the highest number in the 12-year history of the survey. These firms advise over $4.4 trillion in U.S. DC assets, accounting for almost 60% of all U.S. DC assets.*

One of the questions that the survey addresses is loss avoidance at various dates along the TDF glide path. The responses are summarized in the next exhibit.

Exhibit 10: Consultants Set Maximum Loss Targets



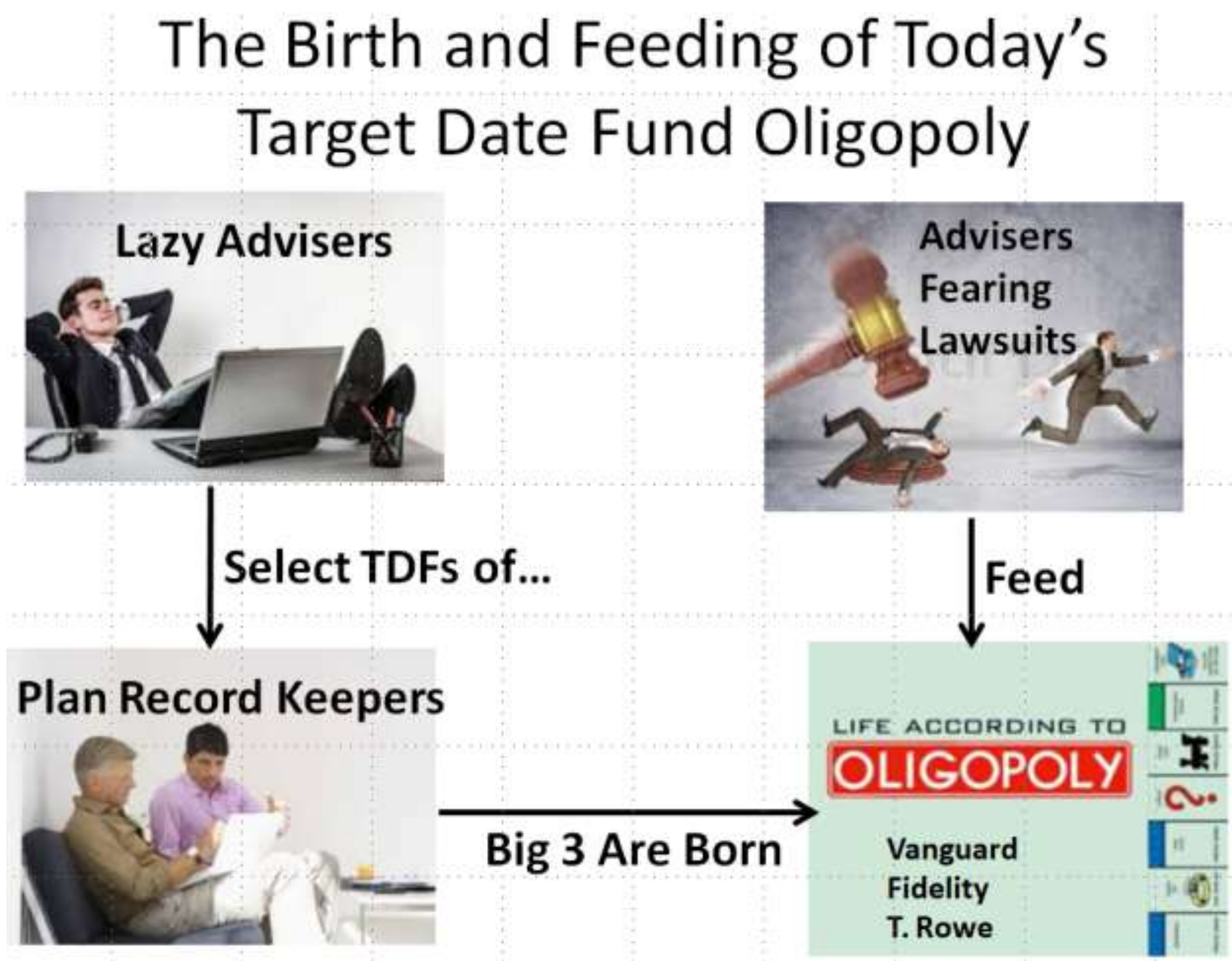
Consultants want TDFs to defend against losses of 10% or more at the target date, and to become even more defensive beyond the target date, defending against losses of 5% or more. These objectives argue for very conservative allocations, assuming that the objective is to have a low probability of the indicated loss. For example, a 10/90 stock/bond mix has a 95% probability of protecting against a 5% loss in a year.

But the fact is that most beneficiaries in TDFs are not safe near the target date because advisors are not choosing safe TDFs. The typical TDF choice is 55% in equities at the target date. The average 2010 fund had 55% in equities in 2008 and lost 30%, plus risk has increased since. Advisors are not choosing safe TDFs because they believe procedural prudence will protect them from lawsuits, as discussed in the next section.

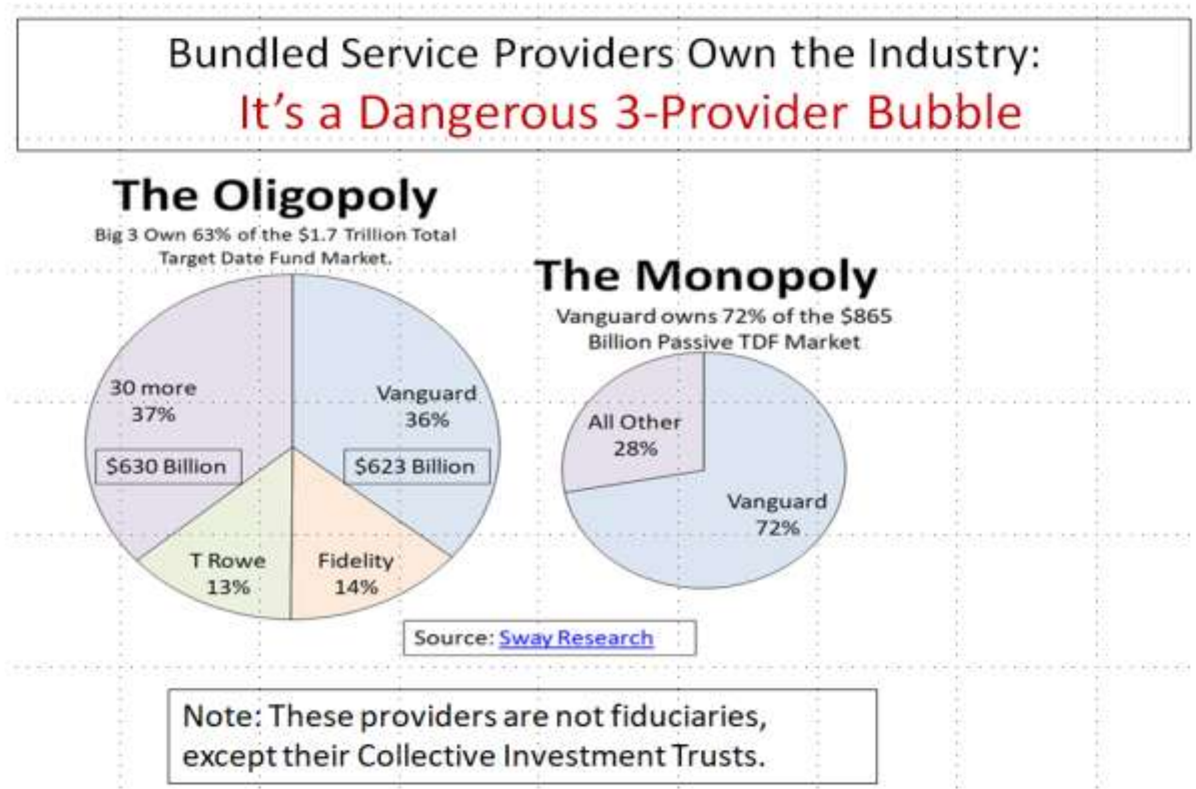
Procedural Prudence: An Oligopoly is Born

Advisers believe that (1) any Qualified Default Investment Alternative (QDIA) will do, and (2) you can't wrong with the Big 3 – Vanguard, Fidelity, and T. Rowe Price -- because everyone else is using them. This is a breach of the Duty of Care that, like our duty to protect our children, holds fiduciaries responsible for harm to our dependents that should have been prevented. Fiduciaries are duty bound to seek the best TDFs for their beneficiaries, but this is not happening.

This practice began with laziness and familiarity that led advisers to use the plan's recordkeeper, and evolved into today's preference for the Big 3, as shown in the following picture:



The details of the Oligopoly are shown in the following picture:



Conclusion

The existence of a TDF oligopoly is a smoking gun confirming the lack of vetting. This would be fine if the Big 3 provided the best TDFs, but they do not. Consequently, choosing the oligopoly is not a safeguard against lawsuits, and very well could be the basis for lawsuits because of the breach of the duty of care. On the other hand, advisors could be sued for choosing safe TDFs because they are different, and have in fact materially underperformed the oligopoly in the past decade. There has been a performance cost associated with prudence in the past decade because imprudent risk has been rewarded.

Lawsuits are unlikely in the absence of harm. No harm, no foul. The next market correction could see the next wave of TDF lawsuits. Time will tell. We will eventually come to know which approach has actually protected advisors from being sued for their TDF selection practices.