benefits
MAGAZINE

Prudent Target-Date Fund Decisions for Fiduciaries

by | **Ronald J. Surz**

The objective of a target-date fund (TDF) should be to preserve a plan participant's savings, rather than to boost their value by taking on too much risk. The author believes many TDFs are still too risky.

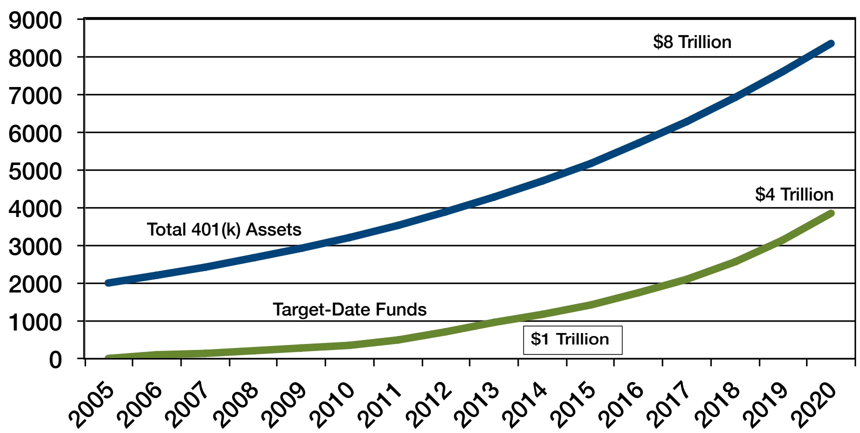
Target-date funds (TDFs) are the most popular investment in 401(k) defined contribution pension plans. They are on a growth trajectory that will take them to $4 trillion by 2020, from their current level of $1 trillion. That's 32% per year growth over the next five years. On a percentage basis, TDFs will increase from 25% of all 401(k) assets to about half (Figure 1).

There currently are 20 million participants in TDFs across 100,000 401(k) plans, and new subscribers default into TDFs every day. Approximately half of all new contributions are going into TDFs, and this percentage will increase to over 60% in just a few years, according to research by Cerulli Associates.

There is a wide variety of TDFs from which to choose. Some are very good. As

FIGURE 1

TDFs Projected to Grow to Half of 401(k) Assets



Source: Target Date Solutions.

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Plan Sponsor Council of America. 2014.

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with most investment products, clever marketing can overcome design flaws. The author believes TDFs should be purchased, not sold.

And despite their growing popularity and importance, there is a lot of confusion surrounding TDFs. Some of this confusion may lead to bad decisions that can harm beneficiaries, exposing fiduciaries to potential legal action. When beneficiaries are harmed by well-intentioned but misinformed fiduciaries, restitution is warranted because fiduciaries should know better. In this case, the defenseless are millions of "little guys" with an average account balance of $80,000 at retirement, often paying 100 basis points each to be in TDFs.

This article addresses TDF misunderstandings and provides guidance for selecting and monitoring TDFs.[1]

Before delving into fiduciary responsibilities and prudent decisions, background on TDFs follows.

What Are TDFs? And Why Are They So Popular?

TDFs were introduced in the early 1990s by Barclays Global Investors (BGI) and originally were used for college savings plans. The target date, for example the 2020 fund, is an event date. In the case of college savings plans, it's the year that a student intends to enroll in a college. The TDF asset allocation mix provides exposure to return-seeking assets, such as equities, in early years when risk capacity is higher. The mix becomes increasingly conservative as time progresses, with exposure switched progressively toward capital-preservation assets, such as short-term bonds (Figure 2). This asset movement through time from more to less risk is called a *glidepath*.

Eventually, TDFs began to be used for retirement savings plans, especially 401(k) plans. The event date in this application is the year in which an investor intends to retire.

Usage of TDFs remained minimal until 2006, when two major events brought them to the forefront. First, behavioral scientists recommended that 401(k) plans use automatic enrollment to encourage participation. Employees would need to choose to be excluded from the plan, whereas they formerly needed to sign on for the plan. Behavioral scientists were right. Participation in 401(k) plans skyrocketed, but this created a new challenge. Many 401(k) participants were either unwilling to make or incapable of making an investment decision, so they defaulted to their employers, which typically placed their contributions in very safe assets, like cash. This led to the second major event: passage of the Pension Protection Act of 2006 (PPA).

PPA specifies three qualified default investment alternatives (QDIAs) that plan sponsors can use for participants who do not make an investment election: TDFs, balanced funds and *managed accounts* (accounts managed by outside professionals). By far the most popular QDIA has been TDFs.

The 2008 Debacle

Subsequent to PPA, TDF assets grew from nothing to about $150 billion in just two short years. This set the stage for serious disappointment in 2008, when the typical 2010 fund lost 30%. As a consequence of this loss, the U.S. Securities and Exchange Commission (SEC) and the Department of Labor (DOL) held joint hearings in 2009 and, subsequently, threatened to regulate TDFs in a variety of ways, specifically by requiring more disclosures. At the time of this writing, these threats remain to be carried out. In the meantime, risk near the target date actually has increased as funds position for the performance horse race.

Popularity

It's important to recognize that most assets in TDFs are there by default, so they are employer-directed rather than participant-directed. Why do advisors and sponsors like TDFs so much?

Fiduciaries like TDFs for their simplicity and the fact that everyone else is using them. TDFs are a single-decision, one-size-fits-all, set-it-and-forget-it approach to investing for the masses. For most plans, TDFs are the preferred choice of QDIA. The other two QDIAs are much less popular for reasons discussed in the following.

The best QDIA from a participant's point of view is a managed account, tailored to the specifics of the individual beneficiary, and the best managed account involves face-to-face individual consulting. But this is expensive, so privately advised managed accounts generally are limited to the executives of companies and unions. Managed accounts for the masses are available through firms like Financial Engines and Guided Choice, but the actual experience indicates that many employees don't use this advice at all or use it incorrectly.

The third QDIA choice—a balanced fund—typically is target risk. Target-risk funds haven't been criticized much yet because they're not that popular, and there are reasons for this lack of popularity. If the plan sponsor chooses one target-risk fund for all of the defaulted employees, the one-size-fits-all criticism has real teeth. How can one level of risk be appropriate for both a 20-year-old and a 65-year-old? Or the plan sponsor could use a family of target-risk funds and place employees into risk groups, but then the sponsor needs some rules for mapping participants into risk groups, and an age-based rule makes sense. Bottom line: The sponsor would take on the role of moving defaulted participants into lower risk funds over time, which is what a TDF is designed to do. A TDF is a sequence of target-risk funds on autopilot.

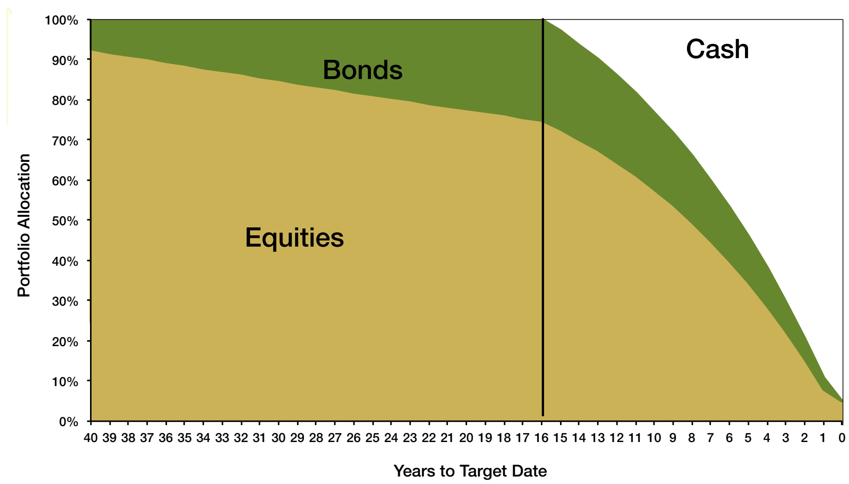
Misperceptions and Prudent Practices

There is a lot of confusion surrounding TDFs, some of it created by DOL. Prudent practices need to see through these misunderstandings, which include:

- Thinking that all QDIAs are prudent
- Accepting the investment objectives promoted by fund companies
- Assuming the largest service pro-

FIGURE 2

Glidepath Transitions From High Risk to Low Risk



takeaways >>

- As the popularity of TDFs as a QDIA continues, it is expected that 60% of new contributions to 401(k) plans will be invested in TDFs within a few years.
- In 2008, the typical 2010 fund—a fund intended for someone about to retire—lost 30% of its value because of a high allocation to equities.
- Many plan fiduciaries have not vetted the TDFs they choose to offer participants, but instead have trusted the largest bundled service providers.
- The objective of a TDF is to preserve a participant's assets as retirement approaches, not to increase the account's value to make up for inadequate savings.
- Every TDF should have a statement of investment policy.

viders are always the right choice because they're big

- Believing that mutual fund companies are cofiduciaries
- Agreeing that risk at the target date should be greater today than it was in 2008
- Accepting guidance that is just not correct, even though it comes from DOL
- Omitting a statement of investment policy.

A description of each misunderstanding follows.

Any QDIA Will Do

PPA establishes certain *forms* of safe harbors (QDIAs), but the *substance*—i.e., the selection of a specific QDIA—remains a fiduciary responsibility. Fiduciaries must decide which form is most appropriate for their plan and strive to select the best funds they can find.

Most fiduciaries have selected TDFs as their preferred form, but they have not done their utmost to find the best TDF. TDFs have not been vetted. For the most part, assets have been entrusted to the largest bundled service providers. These are all fine firms, but the duty of care requires selection on the basis of superiority rather than on convenience and familiarity.

To select the best, fiduciaries must set objectives for their TDF, as discussed in the next section.

Accepting Faulty Objectives

The objectives being sold by fund companies are to replace pay and to manage longevity risk. But these "objectives" won't be found stated in any fund prospectus because they are not true objectives; rather, they are hopes. These hopes "sell" (justify) high risk so fund companies can charge high fees. Marketers sell the "solution" of high risk to compensate for inadequate savings. An objective without a reasonable course of action is a mere hope. No investment glidepath can achieve these objectives. Saving enough is the right course of action for replacing pay and managing longevity risk.

The primary objective of TDFs should be preservation of capital—getting the participant safely to the target date with accumulated savings intact. The Hippocratic oath of TDFs is: *Don't lose participant savings.* This objective guards against foreseeable harm.

Accordingly, zero risk at the target date is the prudent choice. There is a *risk zone* spanning the five years before and after retirement during which lifestyles are at stake. Beneficiaries cannot afford to take risk in the risk zone.

Fiduciaries should not choose TDFs with faulty objectives, like replacing pay and managing longevity risk, because these are too risky at the target date.

Trusting the Big Brands

The three largest providers manage about 65% of all TDF assets, so the belief is that they are the safe and prudent choice. But a look at their risks, especially at the target date, shows otherwise. These providers are making a bet on equity markets that may not pay off.

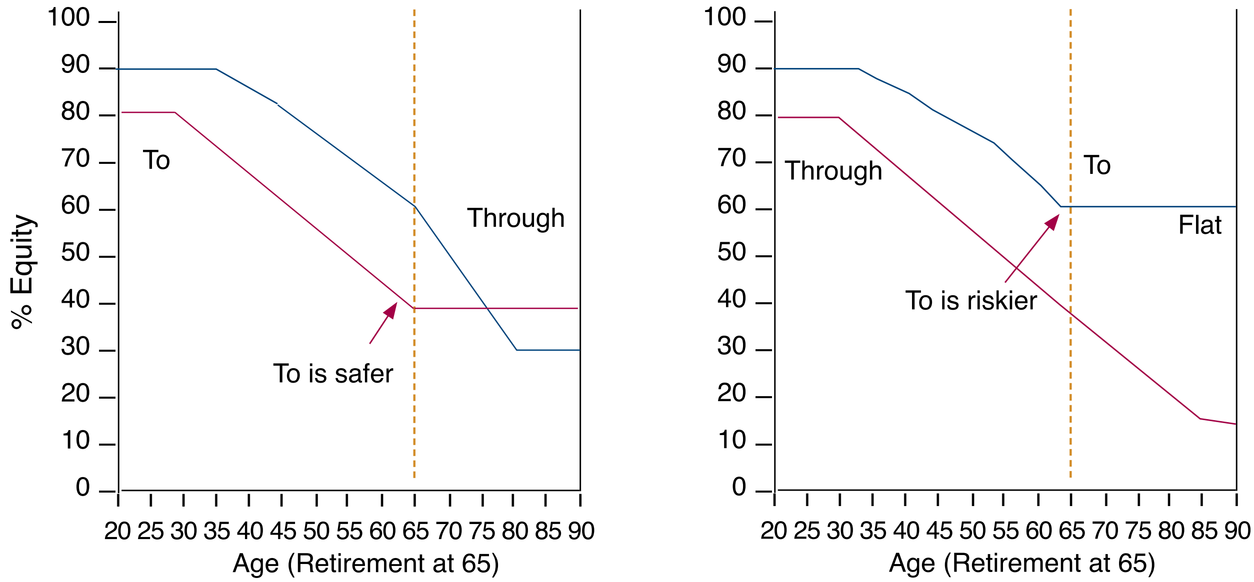
The equity allocations in TDFs from the largest providers are more than 55% at the target date, and the balances of their allocations are mostly in long-term risky bonds. These allocations lost more than 30% in 2008, and there's no reason to believe it won't happen again. It could potentially be worse the next time.

The largest providers' TDFs actually have become riskier since 2008. Ignoring the past (especially 2008) and hoping it will be different the next time is not an option for fiduciaries, and it's certainly not an enlightened view of risk management. Employers that choose one of these TDFs may be signing on for a lot of fiduciary risk, and it's their risk alone because fund companies are not fiduciaries, as discussed in the next section.

We have actually regressed to 2000 when the majority of 401(k) plans had a limited number of investment choices all managed by the same investment

FIGURE 3

The "To Through" Nonsense: "Flat" Does Not Mean "Safe"



manager. It was product without process largely because the word "fiduciary" was seldom discussed. Back in 2000, it was difficult to use the products that competed with the bundled service provider. That has changed in the past 15 years, so fiduciaries really can and should search for the best.

Believing That Mutual Fund Companies Are Cofiduciaries

Following the 2008 debacle, SEC and DOL held joint hearings in June of 2009. One of the many revelations that emerged from those hearings is the fact that mutual fund companies are not fiduciaries to the retirement plan, so they aren't held to Employee Retirement Income Security Act fiduciary standards. By contrast, collective investment funds (CIFs) offered by bank trusts are fiduciaries, and CIFs generally are less expensive than mutual funds. CIFs have gained some market share, primarily from larger plans.

Agreeing to Greater Risk Today Than in 2008

Anyone who watched the joint SEC-DOL hearings on TDFs in 2009 (they were broadcast live on the Internet) would have thought that risk at the target date would be substantially reduced going forward. The entire focus of the hearings was on 2010 funds, for those at or near retirement at the time, and how to avoid a reoccurrence of the 30% meltdown of 2008. In reality, risk has actually increased in subsequent years, so those near retirement are in even more jeopardy today.

The good news about 2008 is that much less was at stake, with $150 billion in TDFs, which was less than 10% of 401(k) assets. The next 2008 will be devastating by contrast. As previously stated, as of this writing TDFs hold $1 trillion, which is about 25% of all 401(k) assets. There will be a public outcry if those nearing retirement suffer substantial losses.

Relying on Misleading Guidance

DOL and other experts have advised fiduciaries to distinguish between "to" and "through" funds and to choose a glidepath that best serves the "demographics" of the plan. The author believes this is bad advice.

"To vs. through" is a distinction without a difference. A "to fund" is supposed to end at the target date and is defined as having a flat equity allocation beyond the target date. Note that a static 100% equity is a "to fund" by this definition. The common belief is that "to funds" hold less equity at the target date because they end there, but the reality is that many "to funds" are riskier than many "through funds," as shown in Figure 3.

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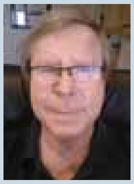

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As a practical matter, all TDFs are "to funds" because most participants withdraw their accounts at retirement. TDFs end at retirement for most beneficiaries.

Demographics have a similar problem. The only demographic that matters is the lack of financial sophistication on the part of those who are defaulted into TDFs. This naiveté argues for safety—Don't lose their money. Consultants have jumped onto the demographic bandwagon as a means to capitalize on TDFs. Consultants and investment-only managers design custom TDFs that purport to match workforce demographics, but there is no one-size-fits-all vehicle that can actually deliver on this matching.

A critical test for a good custom TDF is that it should protect the unsophisticated, especially at the target date, but there are off-the-shelf TDFs that already provide this capital preservation. In other words, custom versus off-the-shelf is a make or buy decision, with some good buy options that should be considered before committing to a custom solution. If the decision is to customize, no risk should be taken at the target date.

Omitting a Statement of Investment Policy

Because they are default investments, TDFs are employer-directed rather than participant-directed, so it's good fiduciary practice for employers to document their decisions. The *statement of investment policy* specifies the objectives the employer has established and the course of action it has taken to achieve those objectives. Every TDF should have a statement of investment policy.

Recommendations

The benefits of TDFs are diversification and risk control, preferably at a reasonable price, so trustees should base their TDF selection on the following:

- Who has the broadest diversification at the long dates when risk is being taken for younger participants? Broad diversification includes global stocks, global bonds, global real estate, commodities, natural resources, etc. The equity allocations of most TDFs are similar at long dates. The differentiator is diversification.
- Who defends best at the target date? Who has the least amount of risk? There is a wide dispersion of equity allocations across TDFs at the target date. The differentiator is safety, i.e., lowest risk.
- Are the fees reasonable, with all-inclusive costs below 50 basis points?

Fiduciaries should avoid making the mistake of selecting on the basis of just one or two criteria. For example, one of the largest providers has the lowest fees but is neither the most diversified nor the most conservative.

Endnote

1. For a more complete and detailed examination, see *Fiduciary Handbook for Understanding and Selecting Target Date Funds,* by John Lohr, Mark Mensack and Ron Surz. The book is among the resources available at www.ifebp.org/news/featuredtopics/retirementsecurity/pages/surveysresearch.aspx.