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When You Choose TDFs, What Use Is Your Consultant?

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Target date funds (TDFs) offer major governance and efficiency benefits versus conventional lifestyle approaches, resulting in overall lower costs and improved member outcomes. But with the TDF approach, how far can defined contribution (DC) fiduciaries economize on their consulting advice? Irrespective of their TDF choice, fiduciaries will still need independent advice for selection, monitoring and other functions. And when it comes to truly open-architecture TDFs and bespoke TDF strategies, we believe that consultants have a wider and invaluable strategic role to play.

Tougher regulation has focused on two key areas in UK DC pensions—more robust governance of pension plans, and demonstrable value for money (VFM) for members. Both of these priority areas align naturally with the TDF approach.

- + By investing each member's account into an appropriate TDF, fiduciaries can ensure there is full transparency into the underlying investments, including attribution of returns, risk and costs—both at the plan and the individual member level. This creates the basis for truly effective governance of the plan investments.
- + With TDFs, because each member's investments are invested in a single professionally managed fund through to the point of retirement, there is no need for continuous switching between different investment vehicles. This eliminates both large numbers of unnecessary transactions and the costs, risks and administrative effort that go with them.

In short, TDFs create the opportunity to revolutionize pension plan governance and administration and so create better outcomes for members. The question is, where does that leave the consultants?

Independent Advice Is Vital

A consultant's primary role is to be the trusted adviser to the trustees and to provide the professional expertise that they may lack. We believe that, ideally, a consultant should operate on a fully independent basis, and so avoid any possibility of conflicts of interest that might prevent full alignment with the trustees' (and thus the members') interests.

In a world of multiple product providers—some of which also provide consulting services—and of increasingly complex product features, independent advice has become ever more important. And it's particularly vital for TDFs. That's because, within the subset of TDF providers and products, there are significant differences in approach and methodology. There can also be big differences in the levels of service and the number of value-adding features that different TDF managers include as standard in their fee scales.

Also, [each pension plan's membership has different characteristics](#), and fiduciaries need the insight to discern which product is best suited to their members' needs. For some plans, a straightforward single-provider packaged TDF range could be perfectly adequate as well as being the most cost-effective option. But more non-standard or sophisticated plans, or plans whose sponsors and/or membership have particular charitable or ethical missions, may need customized or bespoke TDF solutions. These solutions enable fiduciaries to allow for the unique features of their plan membership and/or to incorporate their specific investment and environmental, social and governance (ESG) beliefs into their chosen investment solution.

These complex issues are not easy to evaluate, and require independent, expert advice. But as we explain further below, the consultant can add value in many more ways than simply identifying the most appropriate TDF provider.

Strategic Objectives Come First

It's important not to confuse the choice of investment objectives with the investment strategy and the selection of investment products. Determining the investment objectives should come first. After that, deciding the appropriate strategy to achieve those objectives, and the investment product selection to implement that strategy, are related but separate decisions. The investment objectives for each plan should be based on the specific needs of the membership. It takes expert insight firstly to understand these needs, and secondly to translate them to a statement of investment principles (SIP). The consultant has a key role in providing the necessary insights and guiding the trustees' decision on agreeing the objectives and framing the SIP. Of course, TDF providers may also offer valuable insights at this stage. But it is the trusted adviser who should play the decisive role.

Delegate Your Strategic Asset Allocation

Traditionally, the consultant has taken the lead in the next step—creating a strategic asset allocation (SAA). In the familiar lifestyle model, the consultant designs—and, later, helps to oversee—an SAA matrix that evolves as members approach a target retirement age. The trustees, supported by their consultant, then choose an investment provider (or providers) to populate the individual asset class mandates that are within the lifestyle matrix.

Scenario 1

The Smart master trust investment governance committee (IGC) asked their TDF provider to use their proprietary models to carry out a detailed membership analysis of the underlying plan members. Their consultant had already reviewed the underlying member data and compiled their conclusions. By viewing the data through these two different lenses—and at no additional cost—the Smart IGC were able to arrive at better insights on how to tailor their default solutions' investment objectives to each plan memberships' needs.

From a governance perspective, however, we believe a more effective solution is to delegate the SAA to independently accountable professionals and for the consultant to provide independent review and oversight. Delegating implementation to third-party experts enables the consultant to focus on their core function. That includes independent oversight of the chosen manager, and review of their investment performance and methodology versus the investment objectives and compared to peers.

By contrast, with the lifestyle model, the focus is more often on ensuring the mechanics of the process are functioning in line with the matrix, rather than considering overall investment performance and keeping up to date with best practice. Well-resourced TDF managers have a very wide range of global capabilities, comprising for instance: capital markets forecasting (including currencies and rates); strategist teams staffed by expert economists; quantitative analytics specialists; and trading team insights (for instance, into market volatility and liquidity).

The contrast with lay trustees who agree an SAA with their consultant, and update it perhaps once every three years, is very stark. As the SAA will drive the vast majority of the investment returns and so determine the investment outcome, we believe it is crucial that it should be decided by well-resourced experts and reviewed independently.

From an investment perspective, delegation to professional experts provides further advantages in terms of continuous management and prompt action. With a TDF approach, the SAA is set independently by the asset manager. Each TDF has its own asset mix that is managed to evolve as it approaches a target retirement window. The integrated management of the entire strategy (as opposed to a single mandate) enables TDF managers to prudently adjust the asset allocation to ensure ongoing suitability over the longer term. For some, it also allows for short-term dynamic adjustments to the allocations in real time according to prevailing market conditions.

So the TDF approach represents a huge advance on traditional lifestyle matrices in terms both of governance and investment management.

Consultant Advice and Oversight

The consultant has an important strategic role to play in the TDF model. There are several key functions that need independent expert input, including (but not limited to):

- + identifying the most appropriate TDF provider on the basis of performance, service, risk and all-in cost
- + validating that the chosen TDF manager's default solution is appropriate for the employer's workforce and so can satisfactorily address most members' needs
- + reviewing the TDFs' SAA and validating that the methodology behind it is robust
- + monitoring the evolution of the TDF's SAA, the TDFs performance, the organizational stability of the TDF asset manager and their commitment to ongoing research and product development
- + advising on changes to the TDF's mandate as the plan's SIP evolves for instance, in line with changes to the fiduciaries' specific investment beliefs (e.g. passive versus active) and responsible investing guidelines
- + advising on manager selection for trustees who want to incorporate specific active mandates into customized, open-architecture TDF solutions
- + within that framework, ensuring that the TDF provider continues to offer good VFM

So, in the TDF model, consultants can play a true independent adviser role. They provide strategic oversight and advice, whilst actual implementation is delegated to outsourced experts. The consultants' services are very important even for basic packaged TDF mandates with no customization. And they are vital when fiduciaries adopt more evolved solutions, notably:

- + complex mandates involving wider choice in an open-architecture environment
- + bespoke strategies that require greater investment expertise to understand, monitor and attribute investment performance

Working with Your Consultant

How to Divide Key Functions Between Your Consultant and TDF Manager



Scenario 2

The Greenhouse pension plan trustees were aware that their TDF manager conducted extensive ESG research and integrated ESG factors comprehensively into their investment process. They asked for ESG analysis from their provider—but also asked their consultant to validate that the research was robust.

Potential for Cost Savings

Based on client and consultant feedback, we believe that a switch from a lifestyle to a TDF approach eliminates around 80–90% of investment administration hours. That should correspond to a meaningful reduction in consulting hours in respect of plan administration—the consultant needs to spend less time on routine oversight as the administration process has itself been streamlined. Time and cost efficiencies arise as a result of the elimination of complex lifestyle administration and troubleshooting when problems arise. Audit becomes more straightforward too. The TDF model also means there is no need to spend consulting hours on formulating an SAA or creating and updating a lifestyle switching matrix.

With TDFs, comprehensive performance, cost and risk attribution should come as standard. Any billable consulting hours should relate to reviewing the figures, not compiling them. In fact, the better TDF providers offer a range of value-adding services and analysis. While these can replace consultant input, they can also be supplemented by consultants' independent input.

TDFs automatically adapt their investment strategies to reflect changes in long-term market conditions and to comply with new regulations and legislation. TDF providers should also help fiduciaries with input for their disclosure requirements (e.g. chair of trustees or investment governance committee annual reports). TDFs' portfolio managers are alert to market changes and ready to respond to them. These features can save numerous hours for fiduciaries and their advisers. With TDFs, there is no need to spend time absorbing the ins and outs of new red-tape initiatives or investment market changes. That can be delegated to the TDF provider. Essentially, TDFs take care of the process of change. Consultants can advise whether the TDF provider has done a thorough job and provide market perspectives that compare/contrast the approaches of many different providers.

The Key to Good Governance

In both business and pensions, the key to good governance is to define priority tasks clearly, and then ensure that each team member remains focused on delivering on their specific objectives. It is important to ensure individual accountability (and, ideally, independence) of roles and to prevent conflicts of interests that distort progress toward the ultimate objective. The TDF model makes the priorities and objectives very clear. It ensures that technical investment implementation functions are outsourced to experts. And it releases the consultant to focus on their important role as the core trusted adviser. In the process, it generates substantial cost savings for fiduciaries and plan members.

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