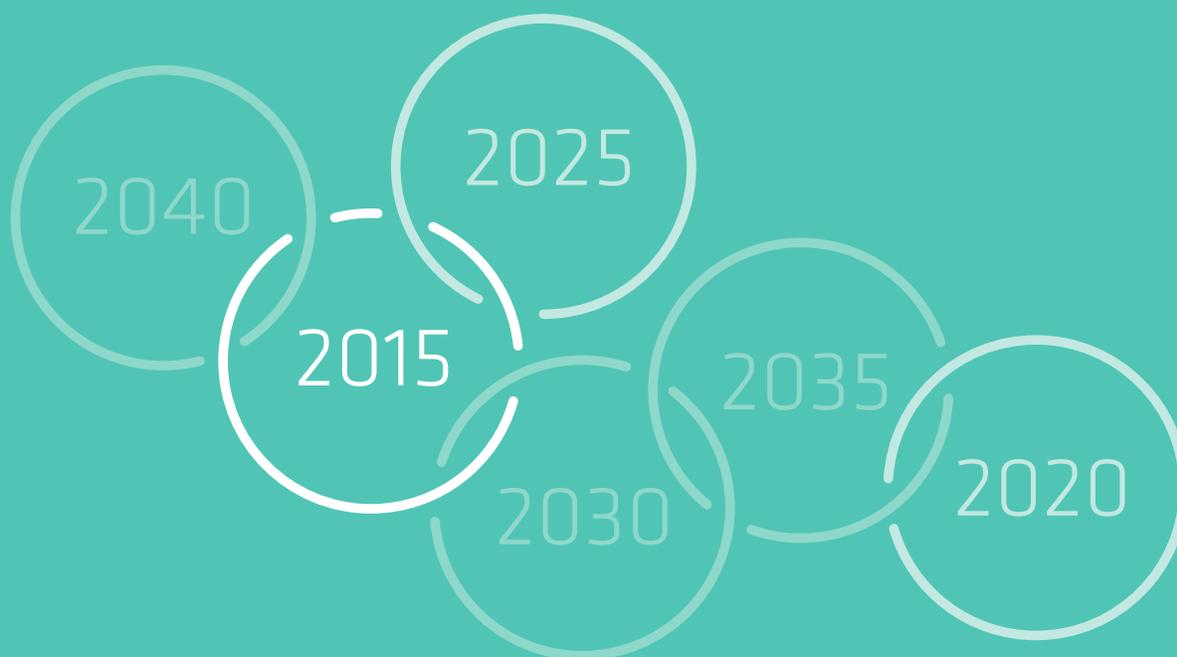




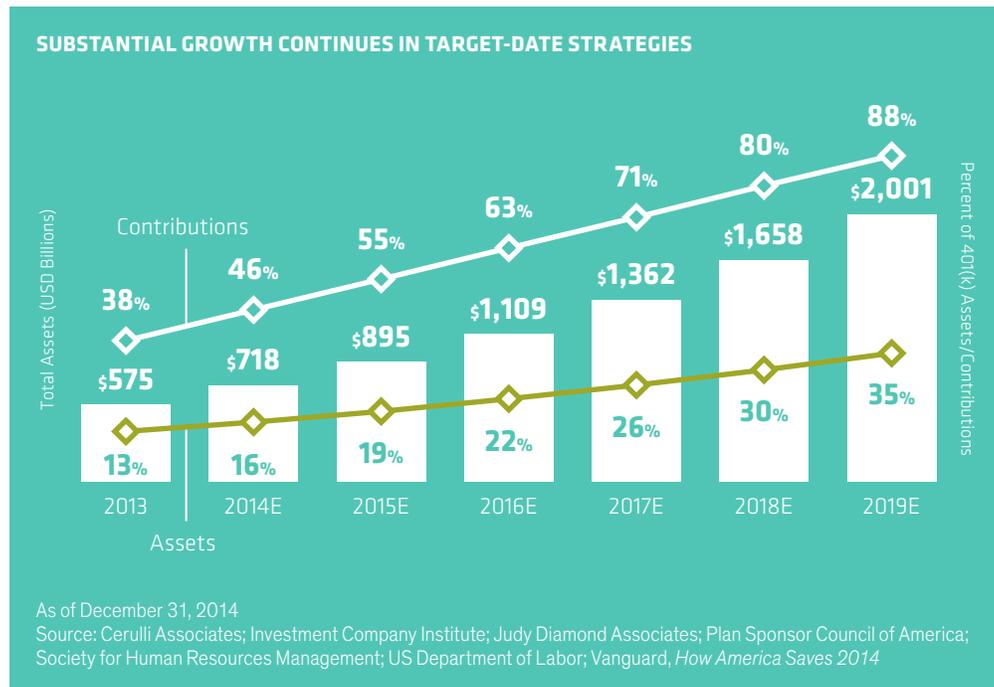
TIME FOR FIDUCIARIES TO REVISIT THE TARGET-DATE FUND DECISION



IN THIS PAPER: Given advances in target-date fund design in recent years and new tips provided by the Department of Labor, we think DC plans should be taking a fresh look at their target-date decisions—and documenting the process. From a fiduciary perspective, it's the prudent thing to do.

The Pension Protection Act of 2006 (PPA) and the 2007 default investment rules from the US Department of Labor (DOL) have dramatically impacted 401(k) and other defined contribution (DC) plans. The rules offered protection from fiduciary liability to plan sponsors who used target-date funds or other “qualified default investment alternatives” (QDIAs) for participants who failed to make investment elections.

The rule changes prompted many sponsors to add target-date funds to their plan investment menus and designate those funds as the plans’ default investments. The resulting growth wave has taken target-date assets to \$575 billion by the end of 2013, and some estimates have them reaching more than \$2.0 trillion by the end of 2019 (Display). This would represent 35% of 401(k) assets.



The percentage of contributions invested in target-date funds is expected to nearly double from an estimated 38% at the end of 2013 to more than 88% by 2019. When plan sponsors choose a default option, target-date portfolios are the clear winner (Display).

Some plans with a target-date QDIA may have made that choice more than a few years ago—since then, there have been a host of legal and regulatory developments as well as advances in target-date design. In many cases, plan sponsors’ recordkeepers didn’t offer a choice in target-date options—proprietary funds were the only option. It may be time to revisit the target-date decision—especially given the plan sponsor’s responsibilities as a fiduciary under the Employee Retirement Income Security Act (ERISA). Working with their financial advisors, fiduciaries should be taking a fresh look at all their investment choices—especially target-date funds.

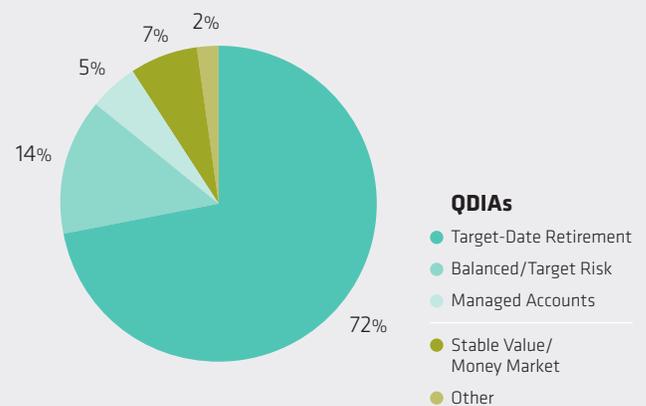
AN EVOLVING LEGAL AND REGULATORY ENVIRONMENT

Since 2006, when the PPA initially created safe-harbor protection for plan QDIAs, several events have changed the fiduciary landscape for DC plan sponsors (see Recent Events Affecting DC Plan Fiduciaries).

Class-action lawsuits have been filed against large plan sponsors, alleging that they failed to perform their fiduciary duties in selecting funds for plan investment menus. The global financial crisis that began in the fall of 2008 left its mark, too—the steep decline in the value of many participants’ 401(k) balances prompted Congress to look more closely at target-date funds. The DOL and the Securities and Exchange Commission each proposed rules that would require plans to provide more information to plan participants about target-date funds. DOL rules took effect that required service providers to disclose fees and investment information to plan sponsors, and required plans to disclose similar information to participants.

These and other events have upped the ante for DC plan fiduciaries. Collectively, they point to the need for fiduciaries to be thoughtful and deliberate about the decisions they make. With respect to target-date fund decisions, the most significant event was the 2013

TARGET-DATE FUNDS ARE THE MOST POPULAR PLAN DEFAULT
Current Plan Default Investment



Based on Callan's 2014 DC Trends survey of 107 plan sponsors, primarily large and mega 401(k) plans as well as governmental and notfor-profit plans. Specific question posed to respondents was: "What is your current default investment alternative for nonparticipant-directed monies?"
Source: Callan Associates

publication of the DOL’s “Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries.”¹

As we’ll describe below, the “tips” outline what prudent fiduciaries should do when selecting target-date funds for their plans. According to the DOL, the tips are intended to provide “general guidance to assist plan fiduciaries in selecting and monitoring TDFs” in participant-directed DC plans. The DOL uses the innocent-sounding word “tips” and refers to them as “general guidance,” but we believe that all plan sponsors whose plans include target-date funds should take them seriously, given the source. To put it more bluntly, plan sponsors who ignore the tips do so at their own peril.

¹ Available on the DOL’s website at: <http://www.dol.gov/ebsa/pdf/fsTDF.pdf>

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DUTIES OF ERISA FIDUCIARIES

In a nutshell, ERISA requires plan fiduciaries to act in the best interest of plan participants “with the care, skill, prudence, and diligence” an expert would use. Failing to meet this high standard can create personal liability for the fiduciary. Fiduciaries aren’t required to guarantee results, but they have to follow a prudent process when they make decisions.

One of the most important fiduciary decisions is selecting a plan default option—in fact, it’s arguably the most important. And it could be the most risky. So far, most lawsuits against DC plan fiduciaries relate to their choice of investments for plan menus—including the selection process, recordkeeping business arrangements and related fees. With respect to target-date funds, many participants with assets invested in these funds didn’t make their own decisions; their plans defaulted them into target-dates. With target-date assets expected to continue growing, this issue won’t be going away.

So, there’s a lot at stake for plan fiduciaries. That’s why it’s important for them to look closely at the DOL tips for guidance when they make an initial target-date choice, or when they reevaluate their plans’

existing target-date funds. The DOL tips provide a roadmap that fiduciaries can follow to help them make a prudent decision—probably the most important decision they’ll make.

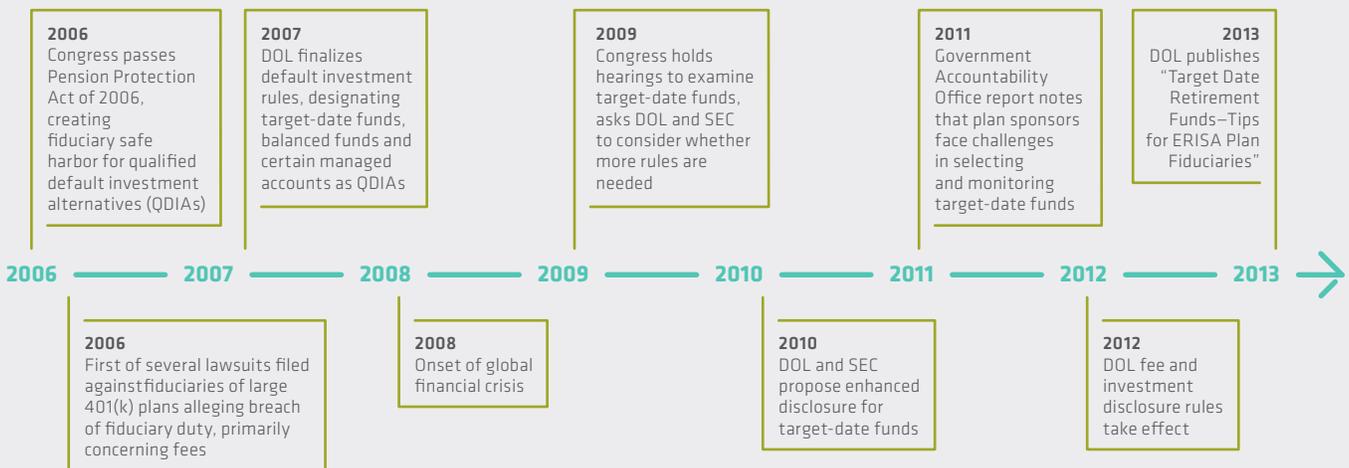
The DOL guidance is important from another perspective: class-action lawyers may try to use that very roadmap against plan sponsors who fail to follow it. They could make the argument that plan sponsors breached their fiduciary duties by not doing what the DOL deems that prudent fiduciaries should do.

THE DOL TIPS: BASIC CONCEPTS—AND MORE

Some of the points the DOL makes in its tips would be relevant in selecting and monitoring any investment option on a DC plan’s menu. For example, the DOL states that plan fiduciaries should establish and document a process for comparing and selecting funds as well as a process for periodically reviewing them. Fiduciaries should also review and understand all fees and expenses associated with the funds.

But the DOL goes on to describe processes specifically relevant to target-date funds. These include understanding the design of the fund’s glide path and whether it will reach its most conservative asset

RECENT EVENTS AFFECTING DC PLAN FIDUCIARIES



allocation at or after the target date. The tips also suggest that plan sponsors understand and examine the underlying asset classes and investments held by the target-date fund.

DOL TO FIDUCIARIES: IS CUSTOM OR NONPROPRIETARY A BETTER FIT?

In our view, one of the most important suggestions in the DOL's tips is that fiduciaries should "inquire about whether a custom or nonproprietary target-date fund would be a better fit for your plan."

Most target-date fund assets are invested in proprietary funds—a single investment manager determines the asset allocation and manages all of the underlying investment components. Based on our own survey of plan sponsors conducted in 2014, 36% of DC plans across all plan sizes offering target-date funds used prepackaged proprietary funds. Of those plan sponsors, roughly one-third said that they did so because the target-date fund was presented as a package along with a recordkeeper's services.

The DOL notes that nonproprietary target-date funds "could offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider." Manager-concentration risk is real, but may be overlooked by plan sponsors in choosing target-date funds. It's unlikely that the same manager is the best choice to manage every asset class. What's worse, if the target-date provider doesn't manage an investment service in a specific asset class, the target-date fund will simply have no allocation to it, even if it's important to a prudent asset allocation.

A defined benefit plan or foundation investment committee, regardless of size, is unlikely to allocate all of its assets to a single investment manager. Target-date funds, when used as intended, will typically account for all of a participant's assets within a DC plan. So, most advisors to fiduciaries would likely agree with the DOL that diversifying exposure to investment providers could be beneficial for participants.

Despite these growing fiduciary concerns, there are few multi-manager target-date fund options available today, except to large DC

THE DOL TIPS IN BRIEF

- + Establish a process for comparing and selecting target-date funds (TDFs)
- + Establish a process for the 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 fund's fees and investment expenses
- + Inquire about whether a custom or nonproprietary TDF would be a better fit for your plan
- + Develop effective employee communications
- + Take advantage of available sources of information to evaluate the TDF and the recommendations you received regarding TDF selection
- + Document the process

plans whose size could economically justify full, open-architecture custom target-date funds.² But multi-manager target-date options are increasingly becoming available, even for smaller plans.

WHAT SHOULD FIDUCIARIES DO . . . AND WHY NOW?

The DOL's tips alone should be enough to motivate prudent plan fiduciaries to take another look at the target-date fund decision—a choice they may have originally made some years ago. Reexamining the target-date decision would document that the plan sponsor has followed a prudent process in making the selection—as outlined in the DOL tips.

But fiduciaries should also consider whether target-date design innovations in recent years would help participants. Multi-manager nonproprietary funds are more broadly available today, and they include enhancements such as strategies for managing volatility and the incorporation of new asset classes beyond traditional stocks, bonds and cash.

² Refer to AB's 2012 paper describing custom target-date funds and their benefits for fiduciaries of large defined contribution plans, "Are Single-Manager Target Date Funds Risky for Large Plan Fiduciaries?", available at <https://www.abglobal.com/Research-Publications/CMA-created-content/Institutional/Summaries/Multiple-Employer-Plans-Safety-in-Numbers.htm>

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The DOL's tips alone should be enough to motivate prudent plan fiduciaries

KEY QUESTIONS FOR PLAN SPONSORS

If you're a plan sponsor and you've decided that it makes sense to work with your financial advisor or consultant to take a fresh look at your plan's target-date offering, here are a few key questions to consider:

When you chose a target-date fund for the plan, did you follow a process like the one outlined in the DOL tips?

If you did, great; if not, it would be prudent to carefully look through the DOL tips, take the suggested actions and clearly document the process. This process may lead to the conclusion that it's time to select a different target-date fund provider. For example, a target-date fund chosen several years ago may no longer be appropriate for participants because of changes in employee demographics, the elimination of a defined benefit plan or another reason.

Did you simply choose the proprietary target-date fund offered by an affiliate of your recordkeeper?

Choosing a recordkeeper's proprietary target-date fund may have been the most convenient choice at the time—and in some cases it may be the only target-date fund available through the recordkeeper. Today, though, most recordkeepers offer funds from many different providers. It's important to understand how the choice of the recordkeeper's fund impacts the plan's overall fees and costs.

Does the target-date fund in your plan allocate to specific managers' strategies or mutual funds that you've eliminated as individual investment options from your plan menu?

If, as a plan fiduciary, you removed a fund from the investment menu because of performance concerns, it could be hard to justify using a target-date fund that still uses that fund as one of its underlying components. However, if you removed an individual investment option from the menu because you believed it would be appropriate for participants to invest in it only as part of a multi-sector portfolio, that could be viewed as a prudent decision. Real assets or alternative strategies might fall under this category.

Have you considered whether recent innovations in target-date fund design would benefit your plan's participants?

As mentioned earlier, managers of target-date funds have added new features that weren't common a few years ago. We think it would be prudent for fiduciaries to consider whether any of the enhancements available today are right for their plans—including dynamic risk management and diversifying asset classes.

Did you look into custom or nonproprietary target-date funds?

We believe that fiduciaries should heed the DOL's suggestion in the tips to ask whether custom or nonproprietary target-date funds "would be a better fit for your plan." As the DOL notes, "they may not be right for every plan, but you should ask your investment provider whether it offers them." In short, know and review your options.

SUMMING IT UP

Many DC plan sponsors have followed evolving best practices and regulatory guidance in adding target-date funds to their plans—often as the QDIA. For those who were early adopters or ahead of the curve in making this move some years ago, we think it makes sense to take a fresh look at that decision—with guidance from your plan’s financial advisor or consultant. There have been a number of advances in target-date design, and these should be considered in taking a fresh look at the target-date decision.

Given the fairly explicit suggestions provided by the DOL, we think it makes sense for this reassessment to closely follow the tips it has provided. This process should also be documented to provide a permanent record of prudent fiduciary behavior.

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