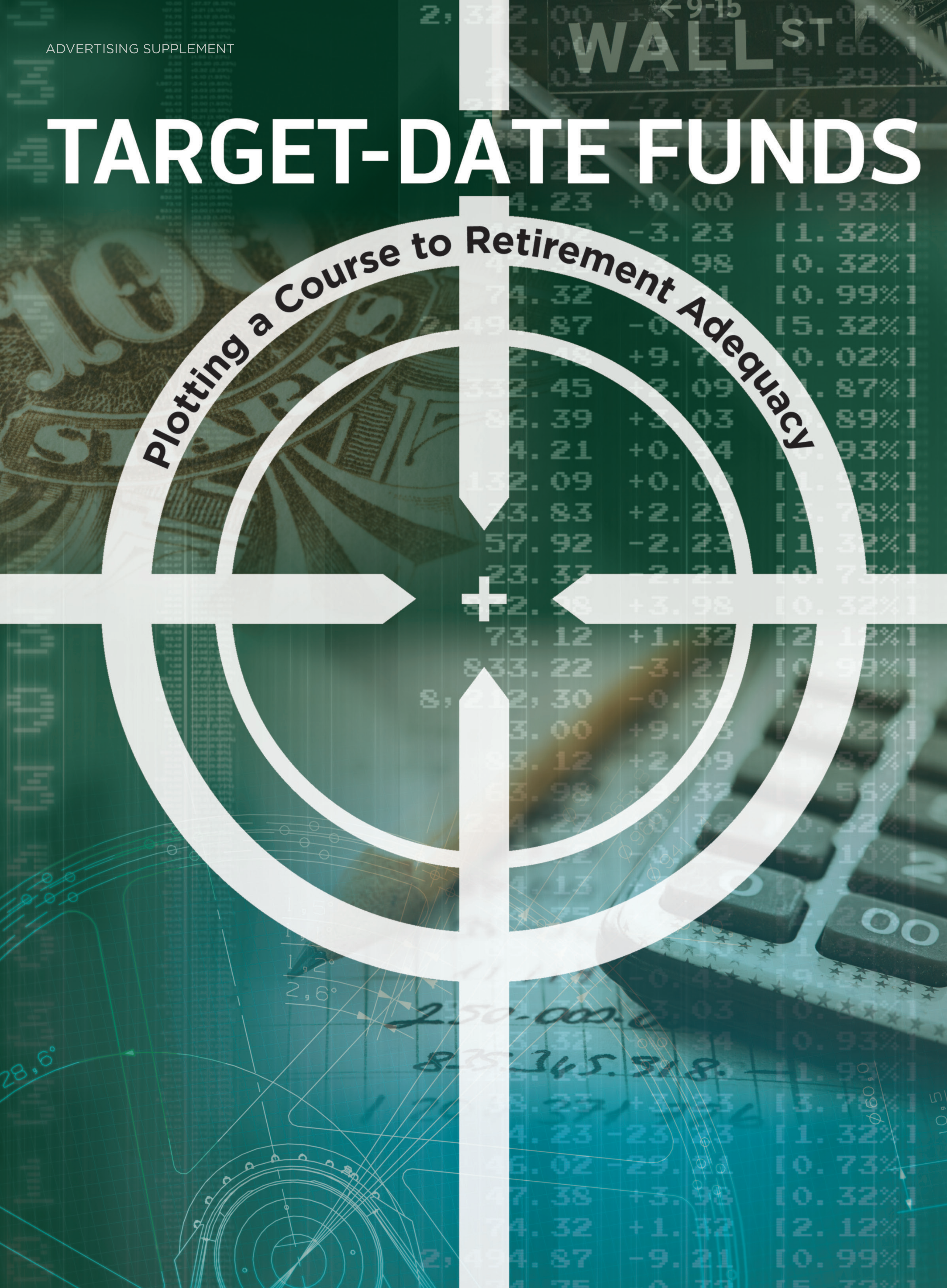
TARGET-DATE FUNDS

Plotting a Course to Retirement Adequacy



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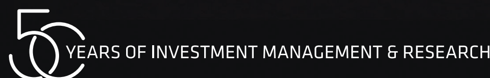

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An Evolving Solution

Target-date funds manage to be both simple and complex as they seek to meet the widely varying needs of participants

It's hard to overemphasize the central role that target-date funds have played in the success of U.S. defined contribution plans. The vast majority of plans, small and large, use target-date funds as their qualified default investment alternative (QDIA). And assets continue to build in these funds as more plans adopt auto-enrollment and a schedule of re-enrollments for participants.

"Importantly, target-date funds leverage the theoretical consensus around human and financial capital," said Philip Murphy, vice president of product management for North American equities and target-date at S&P Dow Jones Indices. "They do that by accumulating financial capital to replace human capital as it is depleted. As participants get closer to retirement, target-date funds derisk financial capital when it is needed to support consumption in retirement. I think this is a pretty good basis for their use as QDIAs."

Many plan sponsors still view their DC plan paternalistically, and the choice of a target-date fund as a QDIA is evidence of that. "Sponsors are choosing options for their default where participants really don't have to do anything," said Jeremy Stempien, a vice president, portfolio manager of Prudential Day One Funds and strategist at QMA.

"Target-date funds are the ideal default option for participants," he continued. "It moves them past the reality that throughout their careers, participants don't typically take action in their retirement plans. They don't revisit their selections on an ongoing basis to ensure they are in a suitable and appropriate investment."

A target-date fund does that for them by derisking over time. At the same time, it typically uses low-fee, institutionally managed underlying products. And it can be built for both working and retirement years.

ASKING A LOT

"The DC market asks a lot of individuals as participants in these plans and many are not in the best position to make really solid investment choices," said Wyatt Lee, portfolio manager of target-date solutions at T. Rowe Price. "They may lack the time, the motivation or at the most basic level, the knowledge to design an investment portfolio that meets their needs."

Lee points to statistics from T. Rowe Price's record-keeping business that support this opinion. "When you look at young investors — those 20 to 35 years old — more than 25% of them consistently have more than 80% of their account balance invested in cash," he said. "These are the investors with the longest time horizon and they should be benefitting from growth assets." At the other extreme, almost 40% of investors between the ages of 55 and 65 have over 80% of their account balance in equities.

Target-date funds give participants an opportunity to have their portfolios managed professionally, and that's particularly important as their retirement assets grow over time.

"It's certainly an improvement over some of the investment behaviors that we were seeing individually from participants," said Sue Walton, senior defined contribution specialist at American Funds, which is part of Capital Group.

T. Rowe Price's Lee points to research from fund tracker Morningstar Inc. that found target-date funds improve participant performance.

"Target-date funds are one of the few areas where the realized return [vs. the reported return] is positive, partly because participants aren't trading and thus continue to dollar-cost average," he said. "This return gap over the last 10 years has been a positive 139 basis points, while for all funds across the investment universe, the return gap is a negative 37 basis points."

What this demonstrates is that by getting participants into an age-appropriate portfolio and getting them to stay invested — rather than buying high and selling low — plan sponsors are paving the way for better results for participants overall.

Plans' activity around auto features has been increasing significantly, largely because of the positive impact on participant behavior.

MOST STAY IN

"When participants are auto-enrolled or default re-enrolled, about three-quarters stay in the age-appropriate target-date fund over the long term," Lee said. "So we do see the vast majority of participants using the products appropriately."

"The prevalence of automatic features — auto-enrollment, auto-escalation and re-enrollment — means that individual participants are using target-date funds correctly," said American Funds' Walton. "That means that they are selecting a single target-date fund that best matches their target retirement date."

Communication with participants is a chance to remind them of the benefits of a target-date fund, especially when they are defaulted into the plan. It may be the only opportunity for plan sponsors to engage with participants if they don't have any intention of doing a deep dive into the specific underlying investment structures and methodology.

"For the plan sponsor, while they want to offer that one-step, easy button approach to participants, they don't want to lose sight of them either," Walton said.

Often the objective of a DC plan is not apparent to the participant, even if it is well-understood by the plan sponsor. There's often a lot of information available on each fund, including the target-date series. "But," S&P Dow Jones Indices' Murphy said, "when you look at the website or participant statements, the target-date is just lumped in with the other choices. There needs to be more emphasis on identifying the key characteristics and decision points in communicating with participants."

From a communications standpoint, the critical pieces of information are always provided: who is managing the target-date fund, why the firm was chosen and what the fund is trying to achieve. Often then, plan sponsors can steer the participant to resources such as their DC plan website that offers access to fund prospectuses and other information that allows participants to dig in.

"The point is to provide the basics but not overwhelm them," QMA's Stempien said. "It's a layered approach where most participants don't move beyond the first layer."

DC plans in general — and target-date funds in particular — require two sets of communications because in effect there are two sets of end users: plan sponsors and participants. Not surprisingly, plan sponsors require much deeper, more specific conversations and materials, what American Funds' Walton called "the how-we-made-the-sausage" conversation that allows sponsors to fulfill their fiduciary responsibilities.

It's necessary to consider the asset classes used in the target-date implementation. Too little diversification can be a problem. Some target-date funds, while still more diversified than some participant's do-it-yourself portfolios, may only include stock and bond allocations.

BEST PRACTICES

"Does the glidepath design utilize the best practices in multi-asset investment management?" asked Christopher Nikolich, head of glidepath strategies in the U.S. for multi-asset solutions at AB. "Does it, for instance, incorporate asset classes beyond traditional stocks and bonds, mix both active and passive, and use strategies to cushion investment losses in the next downturn?"

Plan sponsors need to ensure that their glidepath won't just perform well when equities are going up by 10%, he continued.

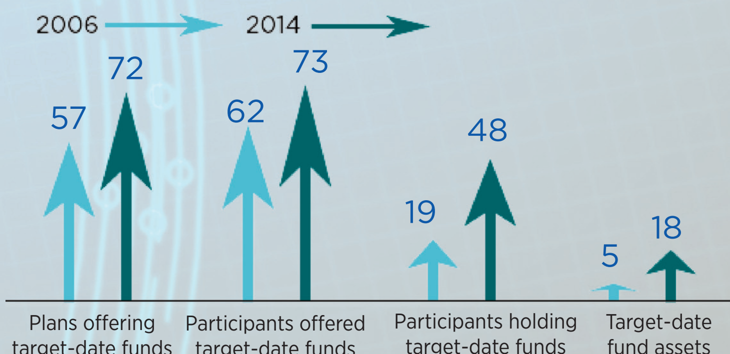
One key place to look for evidence of downside protection is in the short-dated years of a target-date series. It is here that exposure to too much unprotected market risk can be particularly damaging. As was shown in the financial crisis, those close to retirement are vulnerable sharp drawdowns, as they have less time to recover from market losses.

It also makes sense to keep an eye on glidepath construction.

"Glidepath stability is very important," QMA's Stempien said. "When a plan sponsor selects a glidepath, they use a rigorous process to determine the selection that is suitable for their plan, often using an advisor or consultant. If the target-date manager changes the way they manage the glidepath, say, two years later, that can leave the plan sponsor in a very tough predicament with a glidepath that is no longer suitable." •

TARGET-DATE FUNDS' 401(k) MARKET SHARE

Percentage of total 401(k) market; year-end, 2006 and 2014



Note: Funds include mutual funds, bank collective trusts, life insurance separate accounts and other pooled investment products.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project.

The **Reinvention** of **Retirement** Income

After years of pushing annuity-based solutions, target-date fund managers are quietly moving to more market-based ways to deliver income to retirees

The challenge that plan sponsors have been grappling with since defined contribution plans became the primary retirement vehicle for workers has been how to offer retirees lifetime income options that ensure their savings will last through retirement.

In recent years, plan sponsors have — by and large — been successfully focused on the accumulation phase, using programs such as auto-enrollment and re-enrollment that typically default participants into target-date funds. Lifetime income, where the solutions were seen as too expensive, too risky and lacking support from the Department of Labor, sat on the back burner.

DOL'S HOLISTIC VIEW

But last December, the DOL issued a letter in response to an inquiry from an investment manager regarding the potential qualified default status of a target-date fund investment model that gradually allocates a percentage of investment funds to a fixed guaranteed annuity.

"The 2016 DOL letter gives target-date manufacturers more motivation to look at delivering a true outcome-oriented product by incorporating lifetime income into target-date fund product design," said Jeremy Stempien, a vice president, portfolio manager of Prudential Day One Funds and strategist at QMA. "The power of the DOL's comments is the movement toward the idea that less-liquid annuity can be a prudent choice."

More clarity is always helpful, Stempien said, and "this letter certainly does that by building on an already rich host of regulatory guidance going back to 2007." He pointed out that the original QDIA regulation in 2007 included specific guidance on income vehicles in target-date funds.

The recent letter reinforced the importance of "lifetime income products and features as a way to protect participants and beneficiaries," according to the letter.

"We believe that a target-date QDIA with a built-in lifetime income option would meet the requirements of a QDIA if the

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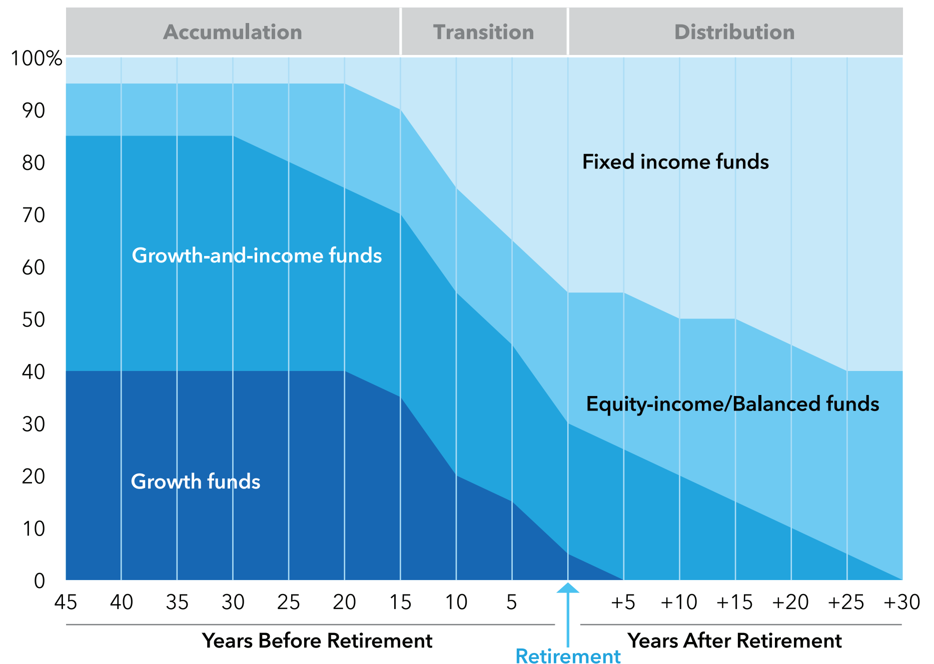

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American Funds investment professionals manage each target date fund's portfolio, moving it from a more growth-oriented approach to a more income-oriented focus as the fund nears its target date (the year in which an investor is assumed to retire and begin taking withdrawals), and continue to manage each fund for 30 years after it reaches its target date. Although the target date funds are managed for investors on a projected retirement date time frame, the funds' allocation approach does not guarantee that investors' retirement goals will be met. The target allocations shown are effective as of January 1, 2017, and are subject to the Portfolio Oversight Committee's discretion. The funds' investment adviser anticipates that the funds will invest their assets within a range that deviates no more than 10% above or below these allocations. Underlying funds may be added or removed during the year.

For quarterly updates of fund allocations, visit **americanfundsretirement.com**.

[1]Relative to their Morningstar indexes since the Series launched in 2007; as of December 31, 2016.

[2]Based on the net expense ratios for American Funds Target Date Retirement Series funds (Class R-3) as compared to the most recent prospectus average expense ratios for the Morningstar Retirement, Medium fee level group, which is composed of target date funds classified by Morningstar as Retirement share class type with a 12b-1 fee greater than 0% and less than or equal to 0.50% as of December 31, 2016.

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option provides for full liquidity at all times," said Christopher Nikolich, head of glidepath strategies in the U.S. for multi-asset solutions at AB. "The DOL December letter did state that products and portfolios with investment guarantees and lifetime income benefits may qualify as QDIAs, if the product otherwise meets the requirements of a QDIA. It's the last part of the sentence that we think is very important."

In particular, Nikolich said a guaranteed lifetime withdrawal benefit (GLWB) meets that test. A GLWB, while still a type of annuity, provides a floor withdrawal amount that is fixed throughout the retiree's lifetime. However, if the portfolio does well, a retiree may receive more than the floor amount and, importantly, any assets that are not used during the participant's lifetime can be passed along to beneficiaries. These products do not have any liquidity restrictions so they would be an acceptable form of lifetime income benefit within a QDIA.

However, Nikolich suggested that many plan sponsors are waiting for additional guidance from the Labor Department before implementing these strategies.

"I don't think the letter will be an immediate catalyst for a significant increase in the adoption of GLWBs in target-date funds," he said.

"If we as an industry really want to replace DB plans with DC, there has to be a more significant consideration of what happens after retirement," said Sue Walton, senior defined contribution specialist at American Funds, which is part of Capital Group. "There is some resistance in the market, though, to using annuities today, given the lack of safe harbor, the high costs, low level of transparency and challenges with portability."

Philip Murphy, vice president of product management for North American equities and target-date at S&P Dow Jones Indices, said partial annuitization can play a role in providing income in retirement "because that strategy offers the benefit of mortality pooling. But that benefit has to be weighed against the disadvantages of losing control of whatever assets you hand over to an insurance company."

The DOL letter signaled that the department is taking a more holistic view of retirement savings, noting that its primary focus when developing the original QDIA regulations was retirement savings and accumulation, not spending needs in retirement. While the guaranteed annuity sleeve of the target-date fund in question did not provide enough liquidity, observers point to the original QDIA rule, which said, "participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least every three months."

"It was the clarity around QDIAs that really gave a push to the target-date industry," said Wyatt Lee, portfolio manager of target-date solutions at T. Rowe Price. "Plan sponsors need some clear standards in place for income solutions to help them understand their responsibilities and give them some protection. That is the big hurdle to the adoption of retirement income solutions."

As lifetime income rises on the retirement agenda, plan sponsors are turning to target-date funds to deliver these options. But to do that, sponsors must keep participants in the plan after retirement, which historically has not happened.

CONTROL AND FLEXIBILITY

"As a plan sponsor, you are a fiduciary to those participants who are working, but also to those who are beyond their working years," QMA's Stempien said. "It's getting more difficult for plan sponsors to pass the buck and ignore retirees in their plans."

"We do see many individuals leaving plans post-retirement," T. Rowe Price's Lee said. "The disconnect for us is that they often roll over into IRAs that have a strategy that is very similar to the target-date fund."

S&P Dow Jones Indices' Murphy said most participants want to retain control and flexibility in retirement and need a structured and prudent way to create a withdrawal plan.

"The next generation of target-date funds is helping manage the risks here, using liability-driven investing techniques as seen in DB plans," he said.

Some of the largest plan sponsors have focused recently on communicating with and educating their participants about staying in the target-date fund after retirement. Sponsors have good reasons for this move. Having more assets in the fund helps to keep fees low, for one thing.

"First and foremost, that means making sure that the target-date fund works into retirement," American Funds' Walton said. "Beyond that is some consideration of what does the plan need beyond the target-date fund for retirees. This can include tools and support around retirement income alternatives and other financial wellness issues."

"There's also the consideration of where participants can go today if they leave the plan," she continued. "It could be as simple as offering a payout fund or combining that with planning tools that bring in other assets like Social Security and savings. Given the discussions around the fiduciary rule, there are benefits to offering a low-cost, institutionally priced and managed fund into retirement for both participants and sponsors."

T. Rowe Price's Lee suggested that it will be more difficult for the DOL to prescribe standards for retirement income solutions because the experience of retirees is far from homogenous.

He suggested that a menu of income options will be needed. These may vary from fully guaranteed, income-generating, insurance-based solutions such as annuities to managed withdrawal or payout strategies that involve no guarantees. Hybrid products or the ability to hold a variety of income products may also help address the problem. One attractive part of this idea is that they could, if used within a target-date fund, take advantage of the benefits of pooling that aren't available to retirees that roll out of the plan.

"As a first step, we see some plan sponsors considering adding a retirement tier," American Funds' Walton said. "Maybe that could include a managed payout fund or series of funds, something that is liquid, well-diversified and low cost. That would be a first step, but it wouldn't have to be the only step. Other options could be added in the future to meet participant needs." •

ARE YOUR PARTICIPANTS USING TARGET-DATE FUNDS CORRECTLY?

Tales of misuse decline as diversification improves, use of CITs increases

Since target-date funds were introduced in 1994, tales have abounded of participants allocating among all the available target-date years or using a target-date fund as a core holding and allocating to other asset classes around it as satellite holdings.

The first example is likely a mistake, while the second may have some merit if considered within a larger wealth strategy. Yet both highlight fundamental misunderstanding about the purpose of a target-date fund selected on the basis of the likely retirement date, which is designed to be a total retirement savings solution.

"There continues to be misuse of target-date funds by participants," said Jeremy Stempien, a vice president, portfolio manager of Prudential Day One Funds and strategist at QMA. "But that misuse is on the decline primarily because as recently as five to 10 years ago, target-date funds were often made available as a core, self-selection investment for participants. Now they are primarily used as the default for new hires, and we see more plan re-enrollments, which continue to reduce the participant errors made around investing in target-date funds."

DIVERSIFIED AND DYNAMIC

Diversification is one of the main selling points of target-date funds. By providing well-diversified, multi-asset portfolios, plan sponsors are addressing one of the key failings of the earlier do-it-yourself approach to retirement planning.

"The fact that target-date funds are diversified, that they are dynamic, that they have professional investment management, but are a set-it-and-forget it option — all this represents a big improvement over many participants' previous investments in their 401(k) plans," said Philip Murphy, vice president of product management for North American equities and target date at S&P Dow Jones Indices.

To QMA's Stempien, that's a mark of success for DC plans.

"Ten years ago, I think many would have said we had a diversification problem," he said. "We had participants largely invested in company stock or cash or stable value — one end of the

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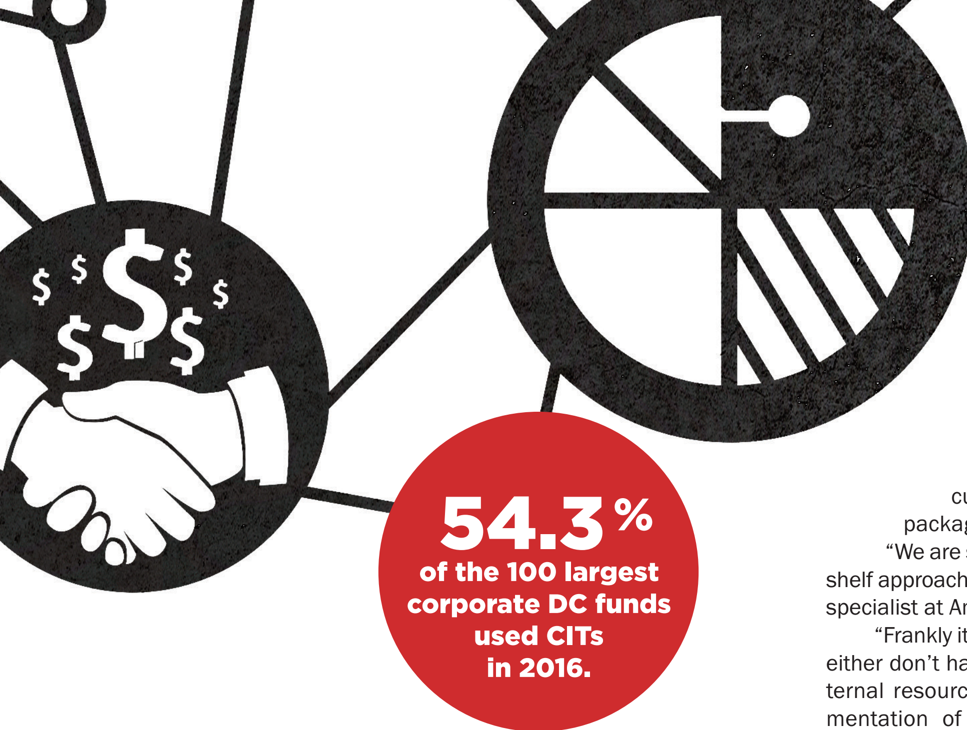

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risk spectrum or the other. Now, because of QDIAs, auto enrollment and re-enrollment, we're actually in a pretty decent place regarding diversification."

Diversification, of course, constitutes a critical component of overall risk management.

Christopher Nikolich, head of glidepath strategies in the U.S. for multi-asset solutions at AB, contended that a glidepath has to have a significant focus on delivering both growth and risk control.

"This means one that delivers return through exposure to equities as well as equity diversifiers that can deliver return in periods when stocks are failing," he said. Often, Nikolich explained, glidepath managers are limited in the strategies that they can utilize, or are not able to make dynamic or tactical decisions.

In the search for diversification, target-date managers are looking farther afield from traditional asset classes, mainly using liquid alternatives, but also such illiquid asset classes as direct real estate. "We are even seeing asset classes like private equity making headway into target-dates," QMA's Stempien said. "Venture capital firms are starting to think about how they can create products for target-date funds."

Custom target-date funds and custom glidepaths continue to be an area of focus for some plan sponsors, particularly larger plans or those with nontraditional populations. "These plans seek a glidepath and asset allocation that's specifically designed for their demographics, both as it relates to growth and risk control," AB's Nikolich said.

Some of these plan sponsors may still have a defined benefit or cash balance plan and need a glidepath that gives a nod to these benefits as it evolves through time.

"Even those plan sponsors that believe their demographics are not unique might want to consider custom," Nikolich said. "We can incorporate both active and passive strategies in a custom strategy. We can also leverage strategies that are already being used in the DB plan or on the core menu of the DC plan to deliver lower cost and better value for money."

GOING BEYOND THE TRADITIONAL

It used to be that multimanager, well-diversified glidepaths that combined both active and passive management were only available in custom target-date plans. Not anymore.

"Today plans don't need to go down the custom route to source these best practices," Nikolich said. "So while we continue to see a growth in custom, we're seeing all the best elements of custom making their way into certain off-the-shelf products."

Off-the-shelf target-date funds offer simplicity, an attractive feature when many plan sponsors are looking to reduce their investment staff and perhaps outsource their investment management and selection responsibilities. "Even some plans that are large enough to justify a custom approach are opting for an off-the-shelf package," he said.

"We are seeing some plans reverting back to an off-the-shelf approach," said Sue Walton, senior defined contribution specialist at American Funds, which is part of Capital Group.

"Frankly it can be very challenging for plan sponsors who either don't have the resources internally or have to hire external resources to manage the glidepath and the implementation of a custom target-date fund." Off-the-shelf target-date funds offer more predictability in terms of the underlying fund management and track record.

CITs EMERGING

One new development in target-date funds is the increased use of collective investment trusts (CITs) instead of mutual funds or separate accounts. While separate accounts have been within the purview of large plans, CITs are fast replacing mutual funds as the administrative structure of choice for target-date funds in plans of all sizes.

An attractive feature of CITs, in addition to low fees, is their administrative simplicity.

"The CIT has to be on a record-keeper's platform, but that's relatively easy to implement," AB's Nikolich said. "They trade at T+1, take daily flows and don't have the same administrative requirements as a mutual fund, such as a mutual fund board or the need to register with the Securities and Exchange Commission. Additionally, CITs are only open to qualified investors."

Some plan sponsors may balk at the idea that a CIT target-date fund doesn't need to register with the SEC, but they are regulated by state and federal banking authorities and are governed by ERISA regulations.

"What we often see is that the target date series mutual fund and CIT are identical to one another," QMA's Stempien said. "By going with the CIT, often plans can save a bit on fees. So there may be no reason not to go with the CIT over the mutual fund version of a series."

But when an asset manager's two structures differ from one another, plan sponsors need to dig a bit deeper to understand the differences. In that case it's critical the sponsor choose the strategy that is most appropriate and consider the structure afterwards.

CITs can have additional uses in custom target-date funds.

"We see sponsors using CITs in custom strategies as the underlying investment vehicles," Nikolich said, "because it can give them the scale to leverage the assets on the core menu or in the DB plan. Multi-asset class and multi-manager pools can efficiently and cost effectively be implemented in CITs. In the adoption of off-the-shelf products, a CIT with CITs underneath allows sponsors to get the best practices of custom in a packaged product." •

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[1]Representative of the Prudential Day One mutual funds vehicle. Gross expense ratio is 1.16%. Net expense ratio is 0.40% as of 12/31/16. Peer group is comprised of all Open-ended Target Date Funds Institutional Share Classes. [2]*Pensions & Investments:* Largest Money Manager's list, May 2017, data as of 12/31/16.

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The Burden of Evaluation

How plan sponsors choose and monitor target-date funds remains a challenging yet critical task

With the majority of corporate defined contribution plan sponsors offering target-date funds as their plan's qualified default investment alternative (QDIA), sponsors' focus has turned to the critical jobs of selecting and assessing those funds.

"Now the focus is on monitoring and evaluating the target-date fund," said Sue Walton, senior defined contribution specialist at American Funds, which is part of Capital Group. "Is it still an appropriate selection relative to their plan objectives and participant needs?"

"Because the target-date-fund landscape is so complex, plan sponsors need to think about the role of the fund in the plan and what outcomes they want for their participants," added Wyatt Lee, portfolio manager of target-date solutions at T. Rowe Price. "The target-date fund needs to be aligned with the objective of the plan."

TWO OBJECTIVES

Once the objective is established, investment managers take that goal and design investment programs to meet it. Although that sounds easy, the issue for target-date funds — and retirement funds in general — is that there are often two objectives that need to be balanced.

"One goal is around wealth. Target-date funds are designed to replace consumption or income in retirement," Lee said. "On the other side is a measure of the volatility of that wealth. So plan sponsors talk about being able to replace income in retirement in a manner that's not so volatile that participants leave the plan. These two goals are at odds with each other."

According to Morningstar Inc., $880 billion was invested in target-date funds (via mutual funds) as of Dec. 31, 2016, representing a substantial increase since the Pension Protection Act of 2006 made target dates an acceptable QDIA. As a result, plan sponsors are spending more time selecting, monitoring and evaluating their funds and providers.

"Even though there is a safe harbor — from a fiduciary standpoint — sponsors need to follow a very specific process on how they evaluate these funds over time," American Funds' Walton said. "It's now a more important topic in committee discussions." But she conceded that if a company also has a defined benefit plan, more than 50% of the discussion could still be spent on that part of the committee agenda.

Choosing the right manager is paramount because target-date funds don't turn over managers as frequently as perhaps other individual strategies in a DC lineup.

"When you hire a target-date manager, you need to be sure that the philosophy of that manager matches with the

plan sponsor's philosophy, and that the methodology addresses the unique risks faced by the plan," said Jeremy Stempien, a vice president, portfolio manager of Prudential Day One Funds and strategist at QMA. "You are partnering with that manager for a long-term engagement."

Similarly, plan sponsors need to look under the hood of the glidepath methodology and construction.

"Not all target-fund glidepaths are created equal," American Funds' Walton said. "It's not just a question of the proportion of equities to fixed income. It's also important to understand the kinds of equities that a participant might have over the life cycle, so the plan sponsor needs to consider how that mix might change over time."

Plan sponsors need to make sure that the equity component of a glidepath is consistent with the plan's risk tolerance. "When you look at glidepaths, you will find that there is more similarity in the far-dated funds," said Philip Murphy, vice president of product management for North American equities and target date at S&P Dow Jones Indices. "They all have a lot of equities. As you get closer to the retirement year, there is much more disparity in the percentage of equities."

SPOTLIGHT ON PARTICIPANTS

Department of Labor guidelines put the spotlight on the participant population, suggesting that plan sponsors have a duty to ensure that the target-date fund fits well with the demographics of the plan. Although this is a legitimate consideration, some managers think that there should be a greater emphasis on the implementation of the glidepath and the performance of the underlying strategies.

"The question I hear the most is whether the glidepath aligns with the demographics of the plan," T. Rowe Price's Lee said. "I think that question goes back to the DOL tips that

were released in 2013, which highlighted the role of demographics. Our research shows that differing demographics have a relatively limited impact on glidepath design."

Unpacking the glidepath and its implementation is not without its challenges, and measuring the success of a target-date manager is tricky. These funds have not been through an entire generation of a participant's life cycle, so some ideas of success are only notional. Nevertheless, plan sponsors need to have concrete standards for how they will define success in the interim — that is, before they have successful retirements to point to as evidence.

16%
increase in target-date mutual fund assets in 2016.

Some of the issues to consider involve the ongoing changes to the glidepath and how these are determined.

"Are these changes strategic or does the manager employ a tactical asset allocation approach?" QMA's Stempien asked. The magnitude of any changes will be important to assess the glidepath's stability.

BENCHMARKS, BENCHMARKS, BENCHMARKS

Benchmarking continues to be one of the biggest challenges plan sponsors face when it comes to target-date series. The only real benchmark will be the final determination of whether participants who have been in the fund for their entire career reach successful retirement outcomes. However, plan sponsors need to monitor and evaluate progress against that goal long before the outcome becomes apparent.

There are single-strategy benchmarks, such as the S&P 500 or cash. There are custom benchmarks designed for a specific target-date series. There are category-average benchmarks or independently constructed target-date benchmarks, such as those that Morningstar constructs. And finally, there are peer performance comparisons.

"But," Stempien counselled, "at the end of the day it's really about how well target-date managers are achieving their objective, and not just performance."

"I recommend avoiding peer group statistics when it comes to benchmarks," S&P Dow Jones Indices' Murphy said. "It can be very hard to determine if you are getting an apples-to-apples comparison."

Just because a target-date fund has the same target date as others doesn't mean that their strategies are comparable. He added that looking at peer performance encourages short-term thinking: When a fund is in a lower-performing quartile, sponsors can be tempted to review and potentially replace it.

"Peer group comparisons simply don't give sponsors enough information to make that kind of choice," Murphy continued. "In addition, peer benchmarks aren't investible and may be subject to survivorship bias."

"We think benchmarking is one of the hardest issues for plan sponsors," T. Rowe Price's Lee said. "It needs to be a multifaceted evaluation. We and most of our peers build a custom benchmark that is effectively a passive replication of our investment strategy. This will allow plan sponsors to know whether we are doing a good job of executing the defined strategy."

It also makes sense to compare a specific target-date fund to a broad universe of these funds, he continued. "But you need to make that comparison through a slightly different lens."

For instance, a strategy with a higher percentage of equities will have done better than a more conservative strategy over the last five years because of the performance of equity markets. "That doesn't mean necessarily that one or other is doing well or poorly. Rather, you need to ask whether your strategy is performing as expected in the current environment," Lee said.

Lee said that while peer benchmarks are becoming more robust, "this area is notoriously difficult and becoming more so because most peer universes are mutual fund universes. As more [collective investment trusts] are developed and do not need to release their performance figures, it means that peer universes may be less representative."

A glidepath, even an off-the-shelf one, is likely to be implemented using a variety of underlying investment strategies and in some cases, managers. However, benchmarking may not simply be a case of measuring under- or outperformance. For each individual strategy, it is important to remember why that strategy is included.

"A manager may have indicated that a certain strategy will underperform its benchmark in a rising market, but is expected to outperform in a declining market," QMA's Stempien said. "That's the lens that plan sponsors should be looking through when assessing performance."

"If target-date was once part of a supplemental plan, but now the DC plan is the primary retirement benefit, then a different evaluation framework may be necessary," American Funds' Walton said.

Results net of fees need to be considered because "if we can provide an additional 50 basis points of results, that translates into real dollars for people," she said. "With all the assumptions that you might make in terms of the typical participants investing over their career, the contributions that they might make, the match formulas they might have — even 50 additional basis points in relative performance could provide up to six additional years of funding in retirement on average."

Target-date funds haven't gained traction with participants because they love and choose them. Rather, target-date funds have been successful because plan sponsors are defaulting participants into them. So the fund company has succeeded in selling the target-date to the plan sponsor, but the plan sponsor needs to be mindful that its participants are relying on its judgment.

QMA's Stempien suggested that plan sponsors need to ask such questions as, "Is the target-date fund series addressing the right risks at the right times for participants?" •

Passive Target-Date Fund? **Not So Fast**

Index strategies gain more ground but glidepaths are an active component

So-called passive target-date funds have made significant inroads in recent years as defined contribution plan sponsors have been swayed by the seemingly inexorable move to index investing. Indeed, indexing provides efficient and cost-effective exposure to certain asset classes, such as those that are very liquid, like large-cap U.S. equities.

But passive strategies also appear to be garnering advocates for less honorable reasons.

"In today's DC environment, for almost every plan, one of their primary concerns is being sued by their participants," said Jeremy Stempien, a vice president, portfolio manager of Prudential Day One Funds and strategist at QMA. "Plan sponsors want to avoid that litigation risk. Most lawsuits are surrounding fees, so plans feel the pressure to reduce fees. The quickest and easiest way to reduce fees is to go passive."

But this approach poses a number of difficulties.

"The only passive thing about a passive target-date series is the underlying manager implementation, meaning the individual components that are used to fulfill those asset classes," Stempien said. "The result will be negative alpha or negative performance relative to the benchmark because there is no opportunity to outperform. And they are going to have a very limited set of asset classes to choose from because many do not have passive offerings."

Sue Walton, senior defined contribution specialist at American Funds, which is part of Capital Group, added: "Somehow we've gotten to this place where plan sponsors actually have a perception that by picking the lowest-cost provider, they will get a free fiduciary pass.

"Fees do need to be considered," she said, "but they are not the only criteria plan sponsors should focus on."

The creation of a glidepath, by definition, involves active decision-making. How much of which asset classes are used in a target-date series glidepath and how that changes over time requires continual active management. As Stempien points out, the implementation of the glidepath may be passive or active.

Many off-the-shelf target-date funds require plan sponsors to make an all-active or all-passive decision on implementation.

"This is in contrast to the way endowments, foundations and defined benefit plans mix active and passive, looking for best-in-class providers and strategies," explained Christopher Nikolich, head of glidepath strategies in the U.S. for multi-asset solutions at AB.

This focus on the underlying management as active or passive has probably confused the issue for plan sponsors, hence the belief that an off-the-shelf passive target-date fund is a fully passive option.

"Many plan sponsors think they are not making a decision by selecting a passive target-date provider," Nikolich said. "Actually, they are making a very active decision to select the asset allocation of the passive provider, which may vary by 20% and 30% between glidepath providers."

Proponents of passively implemented target-date funds contend that plan sponsors need to spend time understanding how active is active in an actively managed target-date. Some active managers are just closet indexers. Others are very active, with high tracking error against a benchmark. It's important for sponsors to understand what kind of active they are buying, when it is intended to work and whether the fees justify the returns received.

Research suggests that it can be difficult for active managers to consistently beat their index benchmarks.

"Target-date funds are made to be good for a lifetime — or at least the working part of a lifetime as you approach the non-working part of it," said Philip Murphy, vice president of product management for North American equities and target date at S&P Dow Jones Indices. "So there needs to be a focus on long-term results, and a healthy degree of skepticism about the ability of any manager to add value with trading in and out of asset classes, or tactically shifting assets."

"On the surface, the catalyst for a greater use of passive investing is a concern about fees and litigation," Murphy said. "The perception is that it is easier to defend oneself as a fiduciary if you choose the lower-cost option. But there are also many fiduciaries and sponsors that appreciate the other inherent advantages of indexing" such as consistent performance against a benchmark.

"It can be difficult for an active manager to outperform an index fund in a single asset class, so how hard will it be for a portfolio of active funds to outperform a portfolio of passive ones?" he continued. "It's not that there is no place for active, but it will be extraordinarily difficult to pick a winning active manager in each of six or 10 sub-asset classes—as found in most target-date funds—vs. a simple portfolio of index funds."

Wyatt Lee, portfolio manager of target-date solutions at T. Rowe Price, said plan sponsors should be looking for managers that can generate an extra 25 or 50 basis points on a net-of-fees basis for participants, which can potentially improve their retirement outcome.

For many managers, blending active and passive management together in the target-date glidepath implementation can be powerful.

"Our view is that we should choose the best active managers that fit our strategy and then use passive managers to anchor some of our exposures, while at the same time reducing fees," QMA's Stempien said.

A combination can also have a positive effect on costs.

"We think about the overall fee budget," T. Rowe Price's Lee said. "That means introducing some fee-reducing benefits of a passively managed strategy in some markets, while enhancing the outcomes for participants with active management. In many markets, passive can give you efficient and representative exposure to a market, while reducing tracking error and fees. Active management gives you increased diversification in market segments that are difficult to access on a passive basis."

The noise created by the debate between active vs. passive investing can cloud the key point that plan sponsors need to remember: "Fiduciary standards for DC plans do not mandate any investment lineup, and don't favor the use of either active or passively managed strategies," Lee said.

Managers agree on the need to consider the value you get for your money rather than simply focusing on the lowest-cost provider.

"Some might argue that from a fiduciary perspective, where you are required to act in the best interest of participants, choosing the lowest-fee provider may only get you what's best and easiest for the plan fiduciary," American Funds' Walton said. "This is a reaction on the negative side to some of the litigation in this area, yet I think we're one market correction away from a reversal of this trend."

While paying exorbitant fees will obviously eat into investment returns, deciding only to pay the lowest possible fees may also result in subpar returns if the strategy is inappropriate or too risky for the participant.

"From a fiduciary perspective, the choice of target-date fund is all about the process," Walton said. "The DOL guidelines make it clear that they want you to focus on your participant needs and understanding your participant demographics. This may not be consistent with a glidepath that is being provided by a target-date fund strategy with the lowest fees." •

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INVEST WITH CONFIDENCE

The Great Myth:
PASSIVE INVESTING ELIMINATES FIDUCIARY RISK

Plan sponsors have a central role in the delivery of retirement benefits to America's workforce. Their decisions enable plan participants to retire with dignity, and sponsors' work requires a level of focus, diligence and commitment that merits respect.

Recently, plan sponsors have come under increased legal scrutiny as the threat of litigation—often involving investment menus and related fees—has become more prevalent across the industry. Naturally, this trend has the attention of plan sponsors. Some have concluded that the safest path to avoid litigation is to eschew active management options and seek the lowest-cost investment provider, under the false assumption that this approach lowers fiduciary risk.

Such a response, while understandable, is not consistent with a plan fiduciary's obligations under the Employee Retirement Income Security Act of 1974 and related interpretations issued by the U.S. Department of Labor and recent court cases.

ERISA calls for plan sponsors to take a wide variety of factors into account when making fiduciary decisions, not fees alone, with an eye toward a sound decision-making process and prudence. In a recently released paper commissioned by T. Rowe Price, "The Misperception of Fiduciary Risk and Active Management in DC Plans: A Legal Perspective," Alison Douglass, partner with the law firm Goodwin LLP, asserts five key guiding principles that can aid fiduciaries in selecting and monitoring investment options within their plan lineup.

Read the full paper at troweprice.com/dcio

IT'S ABOUT THE PROCESS

In order to satisfy ERISA prudence standards, a fiduciary needs to make informed decisions. This means that fiduciaries should have a good decision-making process that they consistently follow.

FIDUCIARIES SHOULD FOCUS ON THE VALUE-FOR-COST PROPOSITION

Plan fiduciaries are not required to scour the market for the cheapest possible investment options. Rather, fiduciaries should focus on the value-for-cost proposition. This means that fiduciaries have latitude to consider what different investment strategies provide to plan participants, and not just cost.

THERE IS NO ONE-SIZE-FITS-ALL APPROACH TO INVESTMENT MENUS

Making good decisions about investment menus requires a fiduciary to understand the available alternatives and know their audience.

RANGE OF CHOICE AND STRATEGIES CAN BE APPROPRIATE

In choosing investment strategies, plan fiduciaries should consider the particular attributes of their plans and may appropriately offer plan participants an array of choices across multiple investment styles and strategies.

FEAR-BASED DECISIONS FALL SHORT OF PRUDENCE

While litigation may be top of mind, fear of lawsuits has no place in fiduciary decision-making. Instead, a well-rounded assessment of investments strategies and options that focuses on participant outcomes and plan objectives should supersede all other factors.

The fiduciary standards and guiding principles highlighted above do not mandate any particular investment lineup and do not favor the use of either actively or passively managed strategies.

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