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THE CASE FOR CUSTOM TARGET-DATE FUNDS



Over the past two decades, target-date funds (TDFs) have become a staple of 401(k), 403(b) and other defined contribution plan investment offerings.¹ TDFs are a compelling option for plan fiduciaries, providing automatic rebalancing to match participants' needs at a low cost. Traditional TDFs are offered as prepackaged investment products that do not allow plan fiduciaries to select underlying investments or customize the rebalancing formula.

Due to these limitations, custom TDFs have become increasingly popular over recent years. Allowing plan fiduciaries to choose investments and a rebalancing strategy, custom TDFs offer a greater degree of control than traditional TDFs. As such, the Department of Labor suggests that plan fiduciaries investigate custom TDFs as a potentially "better" option for their plans.²

The increase in the use of custom TDFs by defined contribution plans has been significant,³ even getting the attention of everyday media outlets. For example, a *USA Today* article explores why plan sponsors are replacing their recordkeepers' proprietary target-date funds with custom target-date funds.⁴ In this paper we explain why plan fiduciaries should consider custom TDFs when selecting the investment options for a 401(k) plan.

A target-date fund primer

Offering investors a long-term investment strategy that combines stocks, bonds and other investments and targets a particular payout date, target-date funds were originally introduced by Barclays Global Investors as a college savings vehicle. Today, TDFs are largely used in retirement planning. The distinguishing characteristic of a TDF is that the mix of investments, or asset allocation, automatically rebalances to become more conservative as a participant reaches a specified retirement date. This shift in the fund's asset allocation over time is known as its glide path. Thus, the TDF provides greater exposure to equities at the beginning of the glide path, when a participant's risk tolerance is higher, and shifts its focus to capital preservation as the target date approaches. A 401(k) plan typically offer a series of TDF options with a range of target retirement dates.

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¹ For ease of reading, the remainder of this white paper will refer simply to 401(k) plans, although the principles and points discussed are generally applicable to all types of defined contribution plans.

² *Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries*, U.S. Department of Labor (DOL), Employee Benefits Security Administration (Feb. 2013) [hereinafter "DOL Fiduciary Tips on TDFs"].

³ See, e.g., Robert Steyer, *Callan: Custom target-date funds gaining in DC plans*, Pensions & Investments, Jan. 15, 2015 (citing a Callan Associates survey to state that "the percentage of plans offering custom funds rose to 22.3% vs. 11.5% in 2013"). See also, Robert Steyer, *Custom target-date zeal grows for participants*, Pensions & Investments, Apr. 4, 2016 (citing a PIMCO survey of investment consultants that reported that the number "offering a custom target-date fund more than doubled in 2015").

⁴ See Robert Powell, *Changes coming to target-date mutual funds*, USA Today, Feb. 16 2015.

Plan sponsors and participants have generally embraced TDFs as a set-it-and-forget-it investment option that does not require active participant involvement. As a result, TDFs have become an increasingly attractive investment option in savings plans — now held by more than 20 million participants across 100,000 401(k) plans.⁵ TDF assets have been estimated to grow to as much as \$4 trillion by 2020 — representing approximately 50% of total 401(k) plan assets at that time.⁶

Plan fiduciaries generally welcome TDFs as part of their 401(k) plan investment strategy. The funds are well-diversified and relatively easy to explain to participants. In addition, government legislation and policy over the past decade have helped encourage and enable the use of target date funds, most notably with the Pension Protection Act of 2006. However, selecting an appropriate TDF is far from simple, as TDFs vary widely in asset allocation, glide path design, risk level, volatility and target date, and can comprise many different underlying funds.

ERISA fiduciary obligations and target-date funds

The Employee Retirement Income Security Act of 1974 (ERISA) imposes a number of fiduciary obligations on plan sponsors and retirement plan decision-makers. For example, plan fiduciaries must act prudently and for the exclusive benefit of plan participants and beneficiaries. These fiduciary obligations extend to the selection and monitoring of plan investments. A plan fiduciary who selects a TDF needs to document that it used an objective process to evaluate the prudence of the investment option. This process should include a review of the TDF's prospectus⁷ (i.e., historic investment return, fee structure, etc.), the fund's glide path (to retirement or through retirement), and how well the fund's goals align with the needs of the employer's workforce, such as typical retirement age or whether a defined benefit pension is offered.

A similar process should be used to meet the fiduciary's obligation to monitor the TDF on an ongoing and regular basis. In addition, the fiduciary needs to be attuned to any material changes in the fund's investment strategy or management team, as these can dramatically affect the fund's appropriateness for the plan.

Drawbacks of traditional target-date funds

The popularity of TDFs is due in part to their one-size-fits-all nature. The downside of this ubiquity is that such generic TDFs may not address the specific and distinct needs of each 401(k) plan. This leads to a number of limitations.

- **No control over underlying investments.** A TDF is essentially a fund of funds. The underlying components generally are proprietary investment funds, all managed by the same fund family. As a result, the plan fiduciary is confined to the TDF vendor's proprietary funds and has no control over the component investment offerings. In fact, the large majority of traditional TDFs are offered by one of only three bundled service providers: Vanguard, Fidelity and T. Rowe Price (more than 70%, according to one recent Morningstar estimate).⁸ While these vendors have significant differences in equity exposure, alternative investments and fund management, being restricted to their proprietary funds represents a considerable concern.
- **Lack of demographic customizability.** Funds vary considerably with respect to asset allocation, equity exposure and volatility. An employer's demographic factors may shape the level of equity exposure that is appropriate for a particular plan. For example, if an employer offers a generous pension plan with subsidized early retirement benefits, its 401(k) plan participants may not need to withdraw their TDF assets until many years after their actual retirement date. This may call for a higher level of equity exposure and risk tolerance, even as a participant's retirement date approaches. In contrast, an employer whose workforce relies solely on the 401(k) plan for retirement income may favor a more conservative investment approach. Other influential factors include the participants' expected longevity, salary levels, turnover, contribution rates and expected retirement age.

⁵ Morningstar (2015), citing Cerulli Associates.

⁶ Morningstar (2015), citing Benefits Magazine (July 2015); citing data from Target Date Solutions (see figure 1).

⁷ Although *DOL Fiduciary Tips on TDFs* explicitly mentions a prospectus (which are available for investments structured as a mutual fund), a "fund fact sheet" or other similar document should be available for a TDF strategy that is structured as other than a mutual fund (e.g., as a collective investment trust).

⁸ Morningstar reports that, as of 12/31/14, 71.2% of TDF assets were concentrated with the three largest bundled service providers, with Vanguard managing 27% of market share (\$192 billion), Fidelity managing 26.5% (\$187 billion) and T. Rowe Price managing 17.3% (\$122 billion). The next largest competitor managed only \$28 billion.

- **Lack of alignment with employer's approach to benefits.** Plan fiduciaries may not appreciate the wide disparity among available funds in a traditional TDF plan when selecting and monitoring investment options. For example, compare the equity exposure for two 2020 TDFs. One provider's 2020 TDF invests 38% of fund assets in equities at the beginning of the glide path, dropping to 30% at the target date. In contrast, another provider's 2020 TDF initially invests more than 65% of fund assets in equities, dropping steeply to 24% at the target date.⁹ These differences will have a substantial effect on each fund's short-term return. An employer that embraces a particular philosophy—whether growth or capital preservation—may find it difficult to coordinate these goals with an off-the-shelf product.

Advantages of custom target-date funds

In a custom TDF, the plan investment fiduciary identifies an asset allocation strategy that is prudent for its workforce and then builds a TDF by selecting each of the underlying investments. In many cases, the plan fiduciary will incorporate the plan's existing core fund menu into the TDF, although the fiduciary is not limited to those options.

As discussed earlier in this paper, ERISA requires that a plan fiduciary act prudently and in the best interest of plan participants when selecting investment options. The Department of Labor has endorsed the selection of TDFs generally as an investment option, even as a default choice for participants who fail to make an investment election.¹⁰ However, the decision as to which TDF to use remains a fiduciary responsibility. Plan fiduciaries remain obligated to determine the type of TDF that is most appropriate for their plan and to seek out the best TDFs available.

The selection of a custom TDF does not, in itself, automatically satisfy a fiduciary's duty of prudence under ERISA. However, a custom TDF offers several specific advantages, which can enable the plan fiduciary to satisfy these ERISA obligations more effectively.

- **Control over key fund elements.** Custom TDFs give the plan fiduciary control over the key fund elements: underlying funds, asset allocation and glide path design. The plan fiduciary can select the most appropriate asset allocation and the best-in-class underlying fund offering in each asset class, as well as shape the asset allocation glide path in a manner that is prudent for the unique characteristics of its workforce.
- **Optimization of the underlying funds.** Custom TDFs allow the fiduciary to select the best fund provider and manager for each asset class in the TDFs. As discussed earlier, the most common TDFs are proprietary and can entirely comprise underlying funds from the same fund family. Such an arrangement might make sense if the fiduciary believes that one fund company offers the optimal funds in all relevant asset classes. While it might be theoretically possible that one fund company has the best fund managers in every asset class, the decisions made by plan fiduciaries often indicate that they think otherwise; many plan fiduciaries select different fund managers for different asset classes in their plan's core menu. In fact, when surveyed, more than 90% of plans using custom TDFs stated that the ability to "use best-in-class underlying funds" (and/or leverage core menu options, as described below) was an important reason for their decision to use custom TDFs.¹¹
- **Incorporating existing plan investments.** Incorporating a plan's existing investments within a custom TDF will make the TDF easier for a plan fiduciary to understand, monitor and communicate to plan participants. This is because the plan fiduciary presumably has already vetted the plan's core funds based on their investment return, fee structure and fitness. In addition, these funds have been carefully selected and monitored, and may be familiar to plan participants.

⁹ Charles Rotblut, *An Investor's Guide to Target Date Retirement Funds in 2016*, Forbes, Jun. 27, 2016 (see table 1 and table 2 comparing asset allocations for various 2020 target date funds).

¹⁰ Labor Regulation 2550.404c-5(e)(4). Indeed, TDFs are the most common default investment option selected by plan fiduciaries. See, e.g., Callan Institute, 2017 Defined Contribution Trends [hereinafter Callan Survey] at 23 (indicating that 88% of surveyed plans used target retirement date funds as the qualified default investment alternative (QDIA)).

¹¹ See Callan Survey at 24.

Conclusion

Custom TDFs are quickly growing in popularity as plan fiduciaries discover their advantages. *Pensions & Investments* reported that more than \$195 billion was invested in custom TDFs in 2015, an increase from \$139 billion in 2014 (these figures included only plans working with investment advisors surveyed by PIMCO, so the true numbers are likely much higher).¹² For a plan fiduciary seeking greater control and contextualization than what a prepackaged TDF offers, a custom TDF may be a more appropriate option. With increasing adoption across the 401(k) plan landscape and support from the Department of Labor, custom TDFs seem like an investment option whose time has come.



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¹² Robert Steyer, *Custom target-date zeal grows for participants*, *Pensions & Investments*, Apr. 4, 2016.

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