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QDIA Fiduciary Red Flags 401k Plan Sponsors Must Look Out For

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One of the objectives of the Pension Protection Act (PPA) of 2006 was to increase retirement savings among workers with defined contribution plans through the use of automatic enrollment. This feature had always been available to plan sponsors, but the fiduciary risks of utilizing that feature. The PPA reduced fiduciary liability for plan sponsors whose plans adopt automatic enrollment in cases where the plan sponsors place those assets in specifically defined Qualified Default Investment Alternatives (QDIAs). More and more 401k participants are choosing to use QDIAs. For employees, this is an easy decision (because, in fact, for many it requires no decision). For plan sponsors, selecting QDIAs at first appeared an easy decision, but events have proven it has placed them in a fiduciary mine field.

From the Employee's Perspective

The PPA required QDIAs to fall under one of three categories: 1) A balanced (a.k.a. "Lifestyle" or "Target Risk") fund; 2) a target date fund (TDF); or, 3) A "model" portfolio. Of these three options, TDFs have become enormously popular. Much has been written about the relative merits of TDFs versus their Target Risk alternatives (see "The Big 401k Fiduciary Question: Target Date or Target Risk?" *FiduciaryNews.com*, May 12, 2015). Relevance to long-term retirement investing merits aside, TDFs have far surpassed Target Risk Funds for one simple reason. "Age-based funds are more popular because they are easier to understand," says P. Jeffrey Christakos of Westfield Wealth Management, LLC in Westfield, New Jersey. "They employee plugs in their projected date of retirement and they are good to go."

Think of it this way: If you're an employee and you're already reluctant to study the various intricacies of long-term retirement investing, you'd find simple "one rule" heuristics to be your favored decision making option. Truth be told, the same applies to plan sponsors who ultimately make the decision on the QDIAs. "It is easier to identify someone's age to

pinpoint the correct default fund, rather than engaging in process to identify their personal risk tolerance," says John C. Hughes, an attorney with The ERISA Law Group, P.A. in Boise, Idaho.

This matters not only when the plan sponsor picks QDIAs, but also when it comes time to explain the reasons behind selecting the QDIAs to employees. TDFs promise a "one decision" alternative that allows retirement savers to focus on saving rather than investing. Benjamin L. Grosz, a benefits and tax attorney at Ivins, Phillips & Barker in Washington, DC, says, "I think that age-based (target date) funds are more popular for participants, because they are understandable and enable a 'set it and forget it' investment selection approach. Target date funds may be more popular (and appropriate) as a QDIA for plan fiduciaries who know and understand that many or most of their QDIA-defaulted participants will not update their investment elections regularly. There is a growing body of behavioral economics research indicating that this is a common behavior as you've written about before in 'Plan Sponsor Alert: Behavioral Finance Reframing Future of 401k,' (*FiduciaryNews.com*, October 1, 2013)."

When compared to the effort required to properly use risk-based funds, TDFs seem quite attractive. "Neither solution is perfect," says Adam Phillips, Senior Vice President & Investment Strategist at EP Wealth Advisors in Torrence, California, "but the use of target funds as QDIA's helps protect employees that lack the understanding or interest to construct retirement portfolios on their own. However, they should not be seen as a substitute for proper employee education around retirement investing. Age-based (target date) funds are popular because they provide clear guidelines for matching employees up with the appropriate investment vehicle. Meanwhile, risk-based offerings force firms to make assumptions about the goals and risk tolerance of underlying employees. This is difficult, when not all young employees have a high tolerance for risk, and older employees are not necessarily risk averse."

QDIA Fiduciary Red Flags for 401k Plan Sponsors

Both TDFs and risk-based funds present fiduciary pitfalls to 401k plan sponsors. These issues are particularly acute for TDFs (see "Are Target Date Funds a Ticking Time Bomb?" *FiduciaryNews.com*, February 10, 2015). We saw how the market crash several years ago exposed the soft underbelly of TDFs. Grosz says, "Many learned during the 2008 financial crisis that risk levels could vary significantly from one 2010 target date fund to another."

While volatile markets cannot be predicted with precision, there are specific warning signs plan sponsors can use when conducting due diligence on TDFs. Grosz counts three: "1) Unreasonably high fees (to investment manager, or others via revenue sharing); 2) Proprietary component funds with unreasonably high fees – (note that even the Department of Labor has suggested that plans consider open architecture or unbundled target-date funds); and, 3) A glide path that is not appropriate or not appropriately communicated." In terms of this latter point, Grosz feels "the onus is really on the plan fiduciary to effectively communicate with participants with regard to their funds' glide path."

Agreeing with and expanding upon Grosz' comment regarding the glide path, Phillips says, "Not all target date funds are created equal, and plan sponsors must conduct thoughtful research to ensure they have proper justification for choosing one target date fund over another. For instance, glide paths vary widely among fund families. While some are designed to arrive at a certain level of risk upon retirement, others continue transitioning several years after the stated retirement date." He also cites two more measures that can be uncovered during the due diligence process. He says, "The terminal level of equities in target funds can differ among providers, leaving some with higher allocations to risk assets than they may realize. Next, many funds are comprised of index funds, while others are a combination of various actively-managed funds (typically of the same fund family). This could leave plan participants vulnerable to higher fees if not properly disclosed. Finally, asset allocation can vary widely among target date funds that appear similar in name. For instance, exposure to international equities could be higher in one plan than another. In addition, some plans may utilize TIPS or other asset classes while other funds stick to more traditional investments."

But there remains one final Achilles' heel with respect to TDFs. "Target date funds assume that all people that are same age have the same financial needs," says Christakos. "Their risk tolerances and risk capacities may be totally different. They anticipate a projected retirement date but may not have the ability to work to that date due to health issues or lack of work opportunities."

This has long been the most damaging issue with TDFs, and one that risk-based funds appear well-suited to address. Here, however, is where plan sponsors need to be most careful. Phillips says a red flag for risk-based funds "is the assumption that is made about the risk tolerance of an underlying plan participant." Indeed, the entire concept of "risk tolerance" has been commonly misused throughout the investment industry, not just without the domain of retirement planning (see "Should 401k Plan Sponsors Ban Risk Tolerance Questionnaires?" *FiduciaryNews.com*, August 13, 2013).

The two primary problems with relying on risk tolerance as a factor in any retirement readiness equation. First, "it is hard to measure risk tolerance accurately," says Christakos. Second, what matters in retirement readiness is not the risk one can tolerate, but the risk one must take to meet one's Goal-Oriented Target (see "How Does Goal-Oriented Targeting Work?" *FiduciaryNews.com*, July 15, 2014). Christakos says "risk tolerance may change over time but the investor may not make the change in their portfolio. They may not match the risk tolerance with their need to accumulate assets. As a result some take too little risk in their portfolio."

How can plan sponsors best reduce their fiduciary risk when selecting QDIAs?

This is the million dollar (or more) question. It's where the rubber meets the road. It's what every 401k plan sponsors is asking or, given the now universal status of QDIAs, should be asking. The answer begins, of course, with re-reading the preceding section. The best way to reduce fiduciary liability is to know what the red flags are and how to identify them.

Beyond that, and a far better answer, is to implement a due diligence process that begins with the basics. For instance, Hughes says, "Be sure that the funds are not just TDFs, but that they in fact meet the definition what constitutes a 'qualified default investment alternative' under the Department of Labor regulations. The title of the fund is not determinative as to whether a fund meets the definition of QDIA; it is the mix of investments contained within the fund. Also, be sure to comply with all of the other conditions of the QDIA regulations. They are not onerous, but there is more to confirm (and document having confirmed) than sending out a notice and putting the money in a fund that someone titled a TDF. In particular, my impression is that many notices are not delivered in accordance with the delivery rules under ERISA when electronic delivery methods are utilized."

Bear in mind this due diligence system can (and should) work with all investment options, not just QDIAs. "The best way for plan sponsors to reduce their fiduciary risk when selecting target date funds (or any investment funds) is to make sure that plan fiduciaries follow a prudent fiduciary process, acting solely in the interests of plan participants, and then document that they did so," says Grosz. "Part of a prudent process will often include consulting with appropriate experts (e.g., investment advisers, legal counsel) depending on the level of expertise of the fiduciary decision makers. Additionally, after the investment funds have been selected, fiduciary risk can also be reduced through good and effective participant communications."

As with most duties involving plan investments, maintaining adequate records is a must. "If there is some special reason why the fiduciaries believe that target risk funds, or target date funds, make sense for their participant population, then they should be sure to document that reasoning, as well as to document if any advisor/consultant made such a recommendation," says Grosz. "I'd also emphasize the point about effective participant communications, particularly with regard to target risk (or target date) funds. Clearly and effectively explaining how these funds work, what they do (and don't do) automatically, and the lack of guarantees is important and can reduce fiduciary risk."

What remains, though, is the never-ending sticky-wicket of employee misapplication and misunderstanding. As Phillips mentioned earlier, there is no collectively perfect solution. The only way to guard against excessive fiduciary liability exposure is to have a fully informed workforce. He says "employee education is paramount. In addition, plan participants must be repeatedly notified of their QDIA exposure and reminded of their ability to opt out of the investment at any time. Plan sponsors should properly document and distribute the guidelines by which they assign specific target funds, as well as a brief description of the underlying fund (e.g. asset allocation, structure)."

As with many aspects of retirement saving and investing, it all comes down to three things: Due Diligence, Documentation, and Education. Of the three, the latter remains the most challenging. Like the proverbial horse, you can lead employees to a periodic education meeting, but you can't get them to learn.

Are you interested in discovering more about issues confronting 401k fiduciaries? If you buy Mr. Carosa's book 401(k) Fiduciary Solutions, you'll have at your fingertips a valuable reference covering the wide spectrum of How-To's every 401k plan sponsor and service provider wants and needs to know.

Mr. Carosa is available for keynote speaking engagements, especially in venues located in the Northeast, MidAtantic and Midwestern regions of the United States and in the Toronto region of Canada. His new book Hey! What's My Number? – How to Increase the Odds You Will Retire in Comfort *is available at your favorite bookstore.*

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