A Buyers' Guide to Target-Date Funds

A prudent process for selecting and evaluating your retirement plan's target-date fund.

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As target-date funds (TDFs) have become the default investment option of choice, there are many factors a plan sponsor should to take into consideration when determining the best fit for their plan. Below we lay out a step-by-step process for evaluating and selecting TDFs.

Executive Summary

- As TDFs continue to gain prominence, it is imperative for plan sponsors to have in place a prudent process to select and evaluate their plan's TDF.
- Care must be taken to evaluate various trade-offs available across TDF offerings.
- Plan demographics and plan sponsor objectives can affect the decision of which TDF may be most appropriate and whether a custom solution is necessary.
- Specific TDF factors such as glide path design, underlying investments, performance, and costs should be regularly evaluated.

Why Is TDF Selection So Important?

Since target-date funds (TDFs) were designated as a qualified default investment alternative (QDIA) in the Pension Protection Act of 2006, their role in defined contribution (DC) plan line-ups has been super-sized. At the close of 2015, total TDF assets (including mutual funds and collective trusts) exceeded $1 trillion. According to a recent survey of plan sponsors by PSCA, TDFs are now offered in 70 percent of DC plans. Among plans that have designated a QDIA, 74 percent use a TDF suite. TDFs account for an average of 16 percent of total plan assets, and with the usage of automatic features (such as auto-enrollment) increasing among plan sponsors, the percentage of plan assets allocated to TDFs is expected to continue to grow rapidly.

While not always the case, plan sponsors are now generally able to select TDFs that are not the proprietary product of their record-keeper. Record-keeping firms that allow plans to offer non-proprietary investment products are said to be "open architecture." The shift in availability has translated into greater choice among TDF products. While having more options is generally a good thing, the number of TDFs on the market, the differences between various TDFs, and the complexity of TDFs as asset allocation vehicles with layers of underlying parts all make the choice of selecting a TDF product a difficult one.

The hefty amount of assets going into TDFs and their use as a plan's default investment option have made it very important for plan fiduciaries to understand the inner workings of these complex products and to select a TDF series that is appropriate for their participants. The Department of Labor (DOL) agrees. The DOL's Employee Benefits Security Administration (EBSA) is in the process of developing a new set of guidelines for TDF disclosures to investors. Furthermore, the DOL issued a set of best practices for TDF evaluation in February 2013, titled "Target Date Retirement Funds — Tips for ERISA Plan Fiduciaries," that outlines aspects plan sponsors should consider in selecting and monitoring a TDF option in their plan.

Guide to a Prudent Process

While such a process should incorporate all of the best practices outlined by the DOL, a prudent process should also include a discussion of the trade-offs associated with the key components of TDFs.

Whether plan fiduciaries are selecting a TDF for the first time, or are confirming that the TDF they currently offer is right for their participants, it is imperative that they establish and follow a prudent and robust process for the evaluation, selection, and monitoring of the TDF product. Such a process should incorporate all of the best practices outlined by the DOL and should include the documentation of a discussion of the trade-offs associated with every TDF.

A prudent process for plan fiduciaries as they evaluate and select the TDFs offered to participants includes two broad steps:

1. An overview of the TDF landscape to help plan sponsors understand the trade-offs associated with key components of TDFs, including glide path design, plan participant demographics, and implementation features. The goal of the first step is to help plan sponsors identify key preferences for a TDF provider.
2. An analysis and comparison of several TDF products that share the preferred criteria identified in the first step. The goal of the second step is to either confirm the suitability of the plan's current provider or to select a new provider that best meets the established criteria.

Step One:
TDF Overview and Analysis of Trade-Offs

First, an understanding of the plan sponsor's objectives for using a TDF needs to be established. Through a robust discussion of how and why TDFs are constructed, and the various trade-offs associated with the components of a TDF, plan fiduciaries will have a better understanding of the type of TDF that will provide the best fit for the plans' participants.

Considerations for Step One include:

- Glide path
- Participant demographics
- Implementation

Glide Path

Understanding the glide path — the exposure to risky assets and how that exposure is reduced over time — is paramount to TDF evaluation and selection. The glide path is the primary driver, in terms of both returns and volatility of those returns, behind the participants' experience and outcome.

In constructing the glide path, a TDF provider is primarily focused on managing two main sources of risk faced by investors planning for retirement: *volatility risk* (also known as shortfall risk or market risk) and *longevity risk.*

Volatility risk: *The risk of a significant loss of market value*

Longevity risk: *The risk of a participant outliving his retirement savings*

TDF providers that are more focused on mitigating longevity risk tend to offer TDFs that have higher levels of exposure to growth-seeking assets along the glide path. Those TDFs that have a more pronounced focus on mitigating longevity risk tend to have a longer glide path, and thus a longer time frame over which to absorb the volatility associated with higher levels of growth-seeking assets. These glide paths, which are sometimes referred to as "through" glide paths, tend to continue decreasing their exposure to growth-seeking assets past the retirement date.

Providers that are more focused on curbing volatility risk tend to offer TDFs that have lower exposure to growth-seeking assets. As these providers are particularly concerned about volatility near the retirement date, exposure of these TDFs to growth-seeking assets at the retirement date is most often lower than that of TDFs offered by longevity risk-focused providers. Some of these glide paths end their de-risking process at the retirement date. Glide paths that reach their final asset mix at the retirement date are sometimes called "to" glide paths.

The slope of the glide path is also important to evaluate, as the pace at which the TDF becomes more conservatively invested introduces an additional risk, called *sequence of returns risk.*

Sequence of Returns Risk: *The risk of market declines and negative returns at a time when assets need to be sold*

Sequence of returns risk brings to light the concept that the timing of experiencing negative returns matters. As participants approach retirement, the impact of a period of negative returns is more pronounced, as there is less time to recoup losses before withdrawals from the account begin (presumably at retirement). A steeply sloped glide path — one that de-risks over a shorter time frame — introduces the risk that in a declining market, assets may be sold as part of the de-risking process when their values are depressed, thus locking in losses.

An analysis of various glide paths, with differing levels of focus on each risk, and an understanding of the trade-offs associated with different glide paths, can help plan fiduciaries identify the type of glide path that would be most suitable for their participants.

Questions for plan fiduciaries to answer to help determine the most suitable glide path:

- Is offering participants the possibility of achieving higher balances at retirement of greater importance than limiting volatility approaching retirement?
- Would you accept a potentially reduced balance at retirement for participants if there was a higher likelihood that balance would be obtained?

Participant Demographics

Another factor influencing TDF preferences is plan-specific demographics. The participant base of most plans is typically diverse, so that analyzing average plan participant data is not particularly meaningful. There are, however, circumstances in which certain plan characteristics can make can impact the TDF decision.

Participant demographic data that may influence plan fiduciaries as they

Questions for plan fiduciaries to answer to help evaluate the impact of participant demographics:

- Are there any participant demographics specific to your plan that may warrant a certain TDF more suitable than another?
- Does the plan design include features that render one type of glide path more suitable than another?

identify TDF preferences include: participants' average age of retirement, availability and participation in a defined benefit plan, participant investment in company stock within the plan, and what participants do with their account balances at retirement. If plan participants have an average retirement date that differs substantially from the average retirement date modeled by a TDF provider or have significant allocations to company stock, plan fiduciaries may determine that a TDF with a glide path that incurs lower volatility may be more suitable. Should plan participants tend to keep their money in the plan through retirement, or if there is evidence that a large majority keep their assets invested in the retirement system (roll over to an IRA, for example), a TDF with a glide path that continues de-risking through retirement may be deemed optimal.

Implementation

TDF providers vary in how they gain exposure to different asset classes. Providers may use passively managed (indexed) strategies, actively managed investment strategies, or a combination of both.

All TDFs are actively managed investments. The asset mix decisions all along the glide path are active decisions made by the TDF provider. However, the implementation of the those allocation decisions can be accomplished through actively managed underlying funds, indexed funds, or a combination of active and indexed products (sometimes called a "hybrid" approach).

Underlying funds that are primarily actively managed enable the portfolio managers of those funds to have the potential to add value relative to an index. TDFs that primarily use actively managed funds to gain exposure to each asset class tend to be more diversified across asset classes. These products tend to include allocations to international bonds, high-yield bonds, real estate, and commodities, for example. The benefits of broader diversification across asset classes include the ability to enhance return and the potential to reduce overall volatility in the portfolio. However, there is no guarantee that those possible benefits will materialize. More so, TDFs with actively managed underlying funds tend to be more expensive than those with primarily indexed underlying funds. They also tend to be more complex products that require a higher level of due diligence.

TDFs with underlying funds that are primarily indexed, or passively managed, tend to be less complex. These products also tend to be less expensive than TDFs with actively managed underlying funds. However, indexed approaches are typically less diversified across sub-asset classes, potentially allowing for more volatility, and do not allow for the possibility of outperforming the benchmark that the passively managed product tracks.

A growing number of TDF products, sometimes called hybrid strategies, incorporate both actively managed and indexed strategies. These strategies tend to allocate to actively managed strategies in asset classes to which they believe they can add value over an index, and allocate to indexed strategies in asset classes for which it is more difficult to add value above an index to bring down costs. Hybrid approaches are gaining traction as many plan fiduciaries view these strategies as a

Questions for plan fiduciaries to answer regarding implementation options:

- Is reducing fees more important than added diversification?
- Would you be willing to offer participants a more complex product in order to potentially achieve better returns?
- Does your committee generally prefer indexed funds or actively managed funds?

Examples of Key TDF Preferences:

Example One:

- A TDF suite with higher levels of exposure to growth-seeking assets to reflect the committee's aim to give participants a higher likelihood of obtaining an account balance at retirement that will last through retirement
- A glide path that extends through retirement, to reflect that most participants retire later than the average retirement age of 65
- A TDF suite that uses passively managed indexed funds as its underlying investments

Example Two:

- A moderate glide path that balances both longevity risk and volatility risk
- A glide path that stops de-risking at retirement
- A TDF suite that has the flexibility to employ tactical asset allocation

compromise between low costs and broad asset class diversification.

Many TDF providers also employ a tactical asset allocation overlay. Tactical asset allocation allows the TDF portfolio managers to make modest tweaks to their strategic glide path to take advantage of (or protect against) shorter-term market movements. These tweaks typically have well-established guardrails, allowing portfolio managers to move within a modest range around the strategic glide path. Tactical asset allocation typically adds expense and complexity to the strategy, and TDFs with passive approaches to implementation rarely have the flexibility to use tactical asset allocation.

Summary of Step One

After the first step of the TDF process is complete, the plan sponsor should have a better sense of the general TDF characteristics that would be most suitable for the plan participants and will be able to identify several key TDF preferences.

Step Two: Selecting (or Confirming) a TDF Provider

After the first step in the process is complete, and the plan sponsor has engaged in a robust process to determine the key TDF characteristics that would be most suitable for the plan, plan fiduciaries are ready to engage in the second step of the prudent process. As a second step, plan fiduciaries should analyze and compare several TDF providers that exhibit the key preferences identified in step one. The analysis should include both quantitative measures and qualitative considerations to highlight the characteristics that differentiate TDF products. In addition, as part of a prudent process as outlined in the DOL's Tips Sheet, plan fiduciaries should evaluate whether a custom TDF solution may better suit participants.

Considerations for Step Two include:

- Custom TDFs
- Experience and Resources
- TDF objective
- Glide path analysis
- Asset class exposure
- Underlying Investments
- Performance
- Cost and Vehicle

Evaluate the Suitability of a Custom TDF

According to the DOL's Tips Sheet on TDFs, plan sponsors should evaluate whether a custom TDF would best suit the plan.

Custom TDFs are products that unbundle the different components of a TDF. Custom TDFs allow a plan sponsor to customize a glide path and/or select specific underlying funds to use within the product. Custom TDFs also entail custom participant communications and allow the plan sponsor to use a custodian of their own choosing.

The benefits of a custom TDF include that a custom glide path can be tailored to a plan's specific participant base and to the plan sponsor's objectives. In addition, customizing underlying investments allows for "best in class funds" selected by plan fiduciaries. Custom TDFs allow for the possibility of reducing expenses by leveraging standalone options, or pension managers, to lower expense breakpoints and gives the plan the flexibility to make changes to any of the underlying components (glide path, underlying investments etc.) without having to overhaul the entire QDIA.

There are some drawbacks to consider. For most plans, the overall cost of custom solutions is higher than for off-the-shelf products. For example, a provider may charge 0.05 percent – 0.10 percent (5 – 10 basis points) for creating a custom glide path and there may be an additional 0.25 percent – 0.50 percent (25 – 50 basis points) expense for custody related operations, such as striking a daily net asset value (NAV), all in addition to the cost of underlying investments. For most plans, the custom glide path is very similar to an off-the-shelf glide path that is readily available.

In addition, custom approaches may require more oversight from plan fiduciaries. Fiduciaries have the responsibility to select and monitor each of the components, including design and implementation of the glide path, and plan sponsors may be responsible for custom fact sheets and communications, potentially increasing the cost of compliance.

Key considerations: Custom TDF

- Is the plan's participant base unique in meaningful ways?
- Can your plan leverage other investment strategies as a means of lowering costs?
- Do the benefits of a custom approach outweigh the all-in costs?

Experience and Resources

An investment organization should have a strong history of managing assets in the defined contribution space to ensure the firm has experience managing retirement assets and an understanding of plan participant behavior. There should be an adequately sized team supporting research on the glide path, as well as evaluating and monitoring the investment options. Given the constantly evolving TDF landscape, providers should also have a demonstrated track record of consistently evaluating their offering to ensure it is competitive and relevant.

The level of assets under management in a TDF solution is also an important consideration. Generally, a TDF provider should have sufficient assets in its product suite to ensure that its TDF offerings have staying power.

Plan fiduciaries should inquire about net cash flows in the TDF product line, to get a sense of the product's potential for growth.

Key considerations:
Experience and resources

- What resources are dedicated to supporting the TDF products?
- How long has the team been in place and how has it changed over time?
- What are the investment firm's TDF assets under management?
- What have the net cash flows in the TDF product been for the past several years?

Investment Philosophy and TDF Objective

Plan fiduciaries' goals and objectives should align with each TDF provider selected for in-depth analysis. For example, goals and objectives may include reducing market volatility as participants approach retirement or minimizing the risk of outliving retirement assets. In addition, some TDF providers have specific income replacement objectives that should be reviewed and considered as to whether or not they are appropriate for the plan.

Income Replacement Level: *The percentage of a participant's final salary (or annual income derived from employment) that a TDF provider seeks to replace annually over the remaining lifetime of the participant*

The higher the income replacement level objective, the higher the exposure to growth-seeking assets the TDF provider would typically need to achieve that objective.

Income Stability: *Participants are able to receive a constant level of real income throughout retirement*

In addition to considering how to accumulate assets leading up to retirement, plan fiduciaries must also be cognizant of the effects of inflation on participant's income level during retirement. Inflation, or the general increasing of prices, can affect the level of real wealth accumulated and the standard of living of participants. Some TDF providers incorporate asset classes designed to mitigate the effects of inflation or design the exposure to such asset classes along their glide path to evolve to attempt to provide a stable level of real income during retirement.

Other TDF providers express the objectives of their solution in broader terms, which may include any of the following:

- To increase the likelihood for participants to attain a higher account balance
- To decrease the likelihood of a participant experiencing a significant loss near retirement
- To get more participants to an acceptable retirement balance

Some TDF providers, whose philosophies are focused on mitigating volatility risk, express their objectives in terms of the expected range of participant outcomes. The TDF solutions of these providers tend to have more conservative (less exposure to growth-seeking assets) glide paths, as the aim is to get as many participants as possible to an acceptable (albeit potentially lower) account balance.

Key considerations: TDF objectives

- Does the TDF provider have a clearly articulated objective?
- Does that objective align with the plan sponsor's?

Glide Path Analysis

One of the most significant ways in which TDFs differ is in their varying levels of exposure to higher-risk, higher-return assets classes (also known as "growth-seeking" assets). The allocation to growth-seeking assets is also a key driver of a TDF's performance and volatility profile. In addition to domestic and international equities, emerging-markets fixed income, high-yield fixed income, real estate, and commodities can be considered growth-seeking assets. Among TDF providers, the range in exposure to growth-seeking assets is wide.

In the examples in Exhibit A, the exposure to riskier assets range from 44 percent to 77 percent of assets for funds with ten years until the expected retirement date. The market decline in 2008 – 2009 brought these differences into glaring focus as funds with higher exposure to growth-seeking assets suffered much steeper declines than those funds with less exposure.

Plan fiduciaries should evaluate each TDF's exposure to growth-seeking assets along the glide path. Not only does this provide insight into the exposure to more volatile asset classes over time, but it also shows the pace at which each provider reduces risk over time. The glide path analysis should include an evaluation of the TDF providers' exposure to risky assets in the years preceding retirement and in the years after retirement and show the point at which each glide path reaches a "landing point" — the point at which the de-risking process is complete and the asset mix remains steady. The glide path analysis should also consider the range of exposures relative to TDFs, so

Exhibit A

	Provider A 2025 Fund	Provider B 2025 Fund	Provider C 2025 Fund
Growth-seeking asset exposure	44%	68%	77%
Fixed income and cash	56%	32%	27%

that plan fiduciaries can also compare each glide path to the broader industry.

Key considerations: Glide path analysis

- What is the level of growth-seeking assets for the plan's youngest participants?
- What is the level of growth-seeking assets at the target retirement date?
- When is the glide path's landing point (the point at which the asset mix remains steady)?
- What is the TDF's final level of growth-seeking assets?

Asset Class Diversification

Plan fiduciaries should consider the level of asset class diversification in each TDF product, as this varies widely between providers. Some TDFs use as few as five underlying funds, reflecting the provider's focus on keeping both costs and level of complexity low. Other TDFs are invested in a much broader array of asset classes and underlying strategies, reflecting the provider's conviction in the benefits of diversification.

Plan fiduciaries should understand the diversification of the TDF across asset classes and sub-asset classes to determine if the level of diversification, and the corresponding level of complexity, is acceptable.

Key consideration: Asset class diversification

- What asset classes comprise the TDF?
- What is the rationale for asset classes, or sub-asset classes, that are excluded?
- Are different asset classes and sub-asset classes used at different points along the glide path?

Underlying Investments

Plan fiduciaries should first understand if the underlying funds are the TDF provider's proprietary products. If the underlying strategies are proprietary, it is important to understand how the performance of those funds is monitored and what the TDF provider's process is for replacing under-performing or sub-optimal funds. If the underlying strategies are non-proprietary, it is important to understand how holdings overlap and risk factors at the total portfolio level are monitored and addressed.

The level of assets in each underlying strategy should be considered. For some asset classes, such as small-cap equity, a large asset base limits the flexibility of the portfolio managers to make investment decisions (buying and selling stocks) quickly. Plan fiduciaries should understand a TDF provider's plans to manage such capacity issues, as assets in TDFs are growing so rapidly. Some providers have added multiple small-cap strategies, while others have added indexed sleeves in addition to their actively managed strategies. Conversely, a low level of assets in a strategy could also be of concern. When new strategies with small assets are added as an underlying strategy for a TDF, plan fiduciaries should consider whether the strategy is being added to the TDF primarily as a means of seeding a new strategy for the firm.

Plan fiduciaries may consider whether the investment in underlying strategies is limited only to the TDF, or if they are open to other investors as well. This is particularly relevant for underlying strategies that have the flexibility to implement tactical shifts in asset mix of the TDF as a whole.

The length of time a portfolio management team has been in place is also an important consideration. Turnover among portfolio management teams could indicate a change in investment process. Plan fiduciaries should know if a track record on a given strategy is that of the team currently in place. Understanding how an organization plans for portfolio manager turnover and transitions is also important.

The performance track record of underlying funds, relative to peers and benchmarks should be evaluated. Performance patterns and expectations for varying market environments should be evaluated in order to understand the impact each underlying strategy will have on the overall diversification and volatility level of the TDF.

Key considerations: Underlying funds

- Are the underlying funds proprietarily managed?
- Are there any underlying funds that are nearing capacity constraints?
- How does management monitor underlying funds?
- Are the underlying funds used exclusively by TDF investors?

Performance

The performance of each TDF relative to benchmarks and to TDF peers should be part of the evaluation process. Plan fiduciaries should understand the composition of the benchmark (current and historical) of the TDF product and determine whether a custom benchmark would be more suitable for evaluating the TDF product's performance. The relevance of performance comparisons between TDF products is limited, as much of a TDF's performance can be explained by its glide path. Relative performance should not be the sole criteria upon which the selection of a TDF provider should be made. However, looking at TDF performance relative to both benchmarks and peers does offer a framework for discussion.

Plan fiduciaries should be able to ascertain the drivers behind a TDF's performance. Performance attribution should include the relative performance based on glide path (or asset class exposure), the value added by underlying fund strategies, and the value (if applicable) added by tactical asset allocation decisions.

While the returns earned for participants are important, so is the volatility participants have to withstand to achieve those returns. An analysis of the volatility of returns for each TDF, as well as risk-adjusted returns of each TDF product, should also be evaluated.

Key considerations: Performance

- Do the funds have an appropriate benchmark?
- Have the funds been able to track (indexed underlying funds) or outperform (actively managed underlying funds) the benchmark over relevant time periods?
- How have the funds performed relative to TDF peers? Is that relative performance understandable given the glide path and the market environment for the time periods being measured?
- How have the funds performed relative to the volatility in returns?

Cost and Vehicle

Expenses are another important consideration plan fiduciaries should evaluate. Like any investment, the expenses of a TDF directly impact results. Not only is it a fiduciary's responsibility to evaluate and monitor expenses, but there has also been an increased focus on fees in recent litigation. A complete analysis and comparison of TDF providers in terms of expenses should be conducted when selecting and evaluating various TDF options.

Often there are several share classes available for each TDF, each containing a different level of revenue credit that can be shared with the plan's record-keeper to offset administrative expenses. An evaluation and comparison of the fund expenses net of the revenue sharing component should be conducted.

Plan fiduciaries should also consider different vehicles of the TDF for which the plan may qualify. For example, a TDF provider may offer a collective trust version of its product, which may be less expensive than a mutual fund version. Often, TDF assets must meet a minimum requirement to be eligible for access to a collective trust.

Key considerations: Cost and vehicle

- How do the expenses of the product compare to the TDFs of other providers?
- What share class is most appropriate for the plan?
- Are there lower cost vehicles available?

Summary of Step Two

After the second step of the TDF process is complete, the plan sponsor should be able to select (or confirm) a specific TDF product that is most suitable for the plan participants.

Conclusion

The two-step process outlined above for selecting and evaluating a TDF offering is a comprehensive one, reflecting the predominant role TDFs play in a defined contribution plan line up. This process incorporates all of the best practices outlined in the DOL's Tips Sheet and by following and documenting these steps, a plan sponsor can confirm a prudent process has been established and followed. It is also recommended that the full two-step process be conducted regularly, as the TDF landscape continues to evolve, individual TDF products change over time, and plan demographics may shift.

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