HANYS Benefit Services

Just the FAQs
for Plan Sponsors

7 Questions Plan Fiduciaries Should Ask About Target Date Fund Strategies

1. What is a Qualified Default Investment Alternative (QDIA)?

The Pension Protection Act of 2006 (PPA) encouraged employers to adopt automatic enrollment features for their participant-directed plans by providing a new type of fiduciary liability relief for “default investments,” or Qualified Default Investment Alternatives (QDIAs). A QDIA is used when a participant fails to make his or her own election. An investment must have specific qualifications to be considered a QDIA. Importantly, a QDIA’s asset allocation strategy need only take into account participant age, and does not need to consider an individual participant’s risk tolerance or other investment assets. One of four types of allowable QDIA’s, Target Date Funds (TDFs) were the QDIA in 95% of retirement plans in 2015 (Source: Vanguard, 2016).

2. What due diligence should plan fiduciaries perform when choosing a TDF?

Target Date Funds were among the four types of investments given QDIA status in 2006 by the PPA. Plan fiduciaries were insulated from some liability for defaulting employee monies into TDF’s and other approved QDIA’s. This implied endorsement of TDFs could have given fiduciaries the impression that the government had done some of their due diligence on TDFs. Our experience in working with clients reveals a high level of interest in following a prudent process for selecting TDF’s. The Department of Labor’s 2013 Guidelines for Fiduciaries on TDF’s clarified the specific due diligence required on TDF’s. The importance for fiduciaries in following this guidance is underscored by the fact that TDF’s are generally the Plan’s QDIA. The selection and monitoring of the Plan’s QDIA requires due care on the part of fiduciaries to limit liability and to enhance employees’ investment outcomes.

TDF’s are a unique investment, requiring more attention than traditional, single asset class mutual funds. The specific process for TDF due diligence should be covered in the plan sponsor’s Investment Policy Statement. Fiduciaries should evaluate the TDF offerings of several investment firms with attention to performance, risk, asset classes included, fees, asset allocation and the glide path. The glide path describes the change in asset allocation and risk over long holding periods. The glide path should be appropriate for the employee population in the Plan.

3. What is the importance of a TDFs glide path in meeting retirement objectives?

Target date funds automatically adjust their asset mixes to become more conservative as investors approach retirement age. This shift in the asset allocation over time is called the TDF’s glide path. Some TDFs’ glide paths are managed “to” retirement, while others are managed “through” retirement. Investment firms consider the following in designing a glide path.

- The risk of outliving retirement assets should be the key driver of managing retirement portfolios so some firms maintain a significant equity allocation based on proprietary asset allocation, modeling and research.

- Time horizon should drive asset allocation throughout investor's life and allocations should continue to shift to more conservative investments for several years after the target date to address the needs of retirees who wish to stay invested in a TDF.
- Active management, coupled with modest tactical asset allocation shifts, can help to enhance long-term performance; which gives the opportunity for outperformance over time.

4. Why adopt a strategy to index some asset classes vs. others?

Long-term Investment performance analysis reveals periods when the majority of active managers cannot beat the performance of passive, index strategies. We are currently in one of those periods. As with other aspects of performance, it is impossible to tell when this trend might change. It has been observed that passive approaches tend to outperform active management in the large cap segment of the market, made up of widely held stocks of large corporations. Active managers may have more opportunity to outperform the index in small caps, bonds (in a rising rate environment) and in specialized areas such as real estate. Therefore, a TDF made up of index funds in all asset classes will have a low fee advantage, and over long holding periods it may offer competitive performance in certain asset classes.

5. Should a plan fiduciary employ an active or passive strategy for managing TDFs?

Passive funds will have lower expense ratios than active, but may lag in tactical flexibility. Active strategies may provide increased breadth of choice in the asset classes that are offered and a broader choice of non-traditional asset classes, such as commodities and real estate investment trusts (REITs). Non-traditional asset classes might not be appropriate as stand-alone options in a participant-directed defined contribution plan; an active TDF portfolio manager can better allocate assets among these non-traditional asset classes and capitalize on tactical tilts. Some firms include a blend of both active and passive underlying funds. All target date funds employ an active approach in the construction of their asset allocation glide paths. Overall, TDFs should be dynamic and flexible enough to adjust as dictated by market conditions.

6. How does a plan fiduciary decide whether a custom or proprietary TDFs is more appropriate?

The opportunity to create a custom TDF solution is limited. The sponsor would engage an investment firm to create a collective trust as the investment vehicle for each portfolio in the series (2020, 2025, etc.). 401(k) plans can hold collective trust investments; 403(b) plans cannot. Plan sponsors may have a goal of lowered fees in creating a custom TDF. Our research indicates that fees for custom TDF's are often higher than proprietary in the under $600 million retirement plan market (total plan assets). Another motivation to go custom would be the ability to create a glide path that is appropriate for the needs of a specific employee population. For example, the firm may have a retirement age of 60, which implies a shift in the glide path from one appropriate for the generally accepted retirement age of 65.

7. What is the horizon for TDFs enhancements?

The success of TDFs has brought them in the focus of the mutual fund industry, investors, plan sponsors and regulators. HBS believes that expense ratios (investment fees) will continue to trend lower driven by competition for assets under management and a greater awareness of fees by plan sponsors. That awareness is manifested by required fee disclosures and class action lawsuits being lodged against retirement plans, claiming excessive fees. In the future we expect to see more TDF's with an option to convert a dollar balance into an income stream for life. These products are currently available but lack portability should the plan sponsor decide to change record keepers. Regulatory: the DOL is also due to release new disclosure rules for target date funds in retirement plans subject to ERISA.

Contact your retirement plan consultant at HBS for information about best fiduciary practices on target date funds in your retirement plan.

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