Pension Plan Fix-It Handbook

Employee Benefits Series | THOMPSON | November 2012 | Vol. 20, No. 2

Target-date Funds Getting Regulatory Attention — For Good Reason

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Target-date funds have emerged as the most popular qualified default investment alternative since the U.S. Department of Labor identified them as an acceptable QDIA. TDFs are designed to match a retirement savings plan participant's equity exposure with his or her distance from retirement age, with the most limited equity exposure occurring at the target date of the fund (usually expressed as the investor's retirement year, for example, the XYZ 2020 fund).

TDFs are complex investments that plan sponsors must understand as they review fee disclosures. This column will touch on some TDF basics by addressing these questions:

Are your plan's TDFs:

- "to" or "through" TDFs?
- active or passive?
- open or closed?
- strategic or tactical?
- designed to meet the needs of your particular workforce demographics?

Morningstar's latest research paper on this topic indicates that "the use of target-date funds has grown more than fivefold from $71 billion at the end of 2005 to approximately $378 billion at year-end 2011." In addition, Vanguard reported that at the end of 2011, 82 percent of plans (for which Vanguard is the recordkeeper) offered TDFs and almost half of all participants in these plans invested in them. The Vanguard Research Note also said, "a total of 24 percent of participants were invested in a single target date fund in 2011, up six-fold over the past five years. Among new plan entrants (those entering the plan for the first time in 2011), a total of 64 percent of participants were invested in a single target-date fund."

Government Scrutinizes TDFs

Government scrutiny of TDFs began when the funds experienced major losses during 2008-10. In late 2010, DOL proposed regulations regarding increased disclosure for TDFs (see February 2011 *The 401(k) Handbook* newsletter). Likewise, the Securities and Exchange Commission proposed amendments to Rule 484 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 that would require additional disclosures for TDFs. These proposed rules were followed by written comments and testimony and a survey on investors' understanding of TDFs that resulted in SEC's reopening of the comment period on the proposed rule amendments. In addition, the U.S. Government Accountability Office issued a report recommending that fiduciaries be required to document relevant factors including "other characteristics of plan participants" used in selecting TDFs as plan participant options.

TDFs are popular with participants because their strategy removes participants from making investment allocation decisions. TDFs also address the issue of participant inertia that often sets in after joining a plan.

However, the SEC survey revealed that many participants do not understand TDFs. In fact, the SEC survey revealed that 54 percent of survey respondents failed to

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realize that TDFs carrying the same date do not necessarily maintain the same asset mix at the target date as they have when participants sign up for them. In addition, the SEC survey revealed that less than one-third of the respondents knew the meaning of the date in the target-date fund's name. Providing education about TDFs to plan participants is paramount.

The answers to the questions asked earlier in the column may help explain why TDF performance can vary among funds with the same target date and why plan sponsors must understand and be able to support their fund selection decisions.

First, let's examine the "glide path" — the investment mix during the life of the TDF where its equity position decreases as the fund approaches its target date. TDFs can be designed so that the glide path changes the mix of investments up "to" the target date or "through," including beyond, the target date.

In addition to the glide path, plan sponsors must decide upon an actively managed TDF versus a passively managed one, or some combination. Likewise, should the TDFs selected contain offerings from only one fund family (closed) or offerings from multiple fund families (open)? A passively managed TDF should not be so expensive as an actively managed TDF. A closed approach could result in less expense. A passively managed, closed TDF could be the least costly option. But is it the best selection for the plan's demographics? The Morningstar report finds that there is no significant advantage to either the open or closed approach.

Should the TDFs' investment allocation strategy permit a certain amount of tactical allocation into investments that don't necessarily follow the overall strategy of the TDFs? That is, should the TDFs provide for short-term investments that could improve their overall performance?

The questions are many and this column touches on only a few, as an overview. The challenge for plan sponsors is to understand TDFs' glide-path strategy, select the appropriate TDFs for their plan's demographics and then communicate about them to participants. Understanding the glide-path strategy includes comprehending the underlying asset classes and the manager's ability to deviate from the stated objectives.

Philosophical and risk management vary among target-date series in the years leading up to the retirement date. It is important for plan sponsors to understand the TDF manager philosophy and determine whether it meets the needs of their participant demographics. For example, a plan in which participants historically withdraw account balances at retirement might consider a "to" strategy. A plan in which participants historically keep their money in the plan could be either "to" or "through" strategy depending on other available retirement plans. An employer with a defined benefit plan might select a TDF with a "through" strategy because market fluctuations at or near the participant's retirement age would be offset by the defined benefit stream of payments. Participants with larger account balances could conceivably withstand more risk and larger market swings, but not all participants are alike.

Match Your TDFs to Participant Demographics

There are conservative young participants, as well as older participants willing to invest aggressively. There are many possible scenarios; the bottom line is that the plan sponsor should understand its own plan's demographics and match it with appropriate TDF options. This will require a carefully documented selection process and ongoing monitoring of both the participant demographics and the TDFs. Plan sponsors may find that the best way to address their plan's demographic profile is through a custom-built TDF.

The GAO report offers suggestions about TDFs for plan sponsors, including:

- have clearly defined goals for the QDIA and select the TDF accordingly;
- take into account the plan demographics when analyzing various TDFs. Demographic considerations include industry, turnover rate, retirement age, etc.;
- get expert help if needed in selecting the TDF;
- determine how to benchmark the TDF; while a popular investment choice, TDFs haven't been around for very long and the variances among them are many; and
- provide investment education about TDFs; just because a TDF was the default investment doesn't necessarily mean it is the right investment for all participants.

Remember to document the decision process used to select the TDFs used in your plan.

Finding out More

To read the Morningstar 2012 research paper on TDFs, click this link: http://corporate.morningstar.com/

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us/documents/MethodologyDocuments/MethodologyPapers/TargetDateFundSurvey_2012.pd

To see the Vanguard research, click this link: https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvResTargetAdoption2011

To review the SEC investor survey, click this link: http://www.sec.gov/comments/s7-12-10/s71210-58.pdf

To read the GAO report, click this link: http://www.gao.gov/new.items/d11118.pdf