TARGET DATE FUNDS

Target Date Funds (TDFs) have quickly become a large and important part of defined contribution plans. In this publication, we will provide a review of the current state of TDFs, pointing out trends in usage and changes in the types of funds available. We will also suggest some tools that can help plan sponsors in evaluating the characteristics of TDFs and some tips on selecting an appropriate fund series for your specific plan.

Introduction

A target date fund (TDF) is a single investment option that provides a diversified, professionally-managed mix of stocks, bonds, and other investments, is automatically rebalanced, and becomes more conservative over time. The primary intended use is to provide professional asset allocation over a participant's complete retirement savings horizon including the accumulation and de-accumulation phases. Participants select the year they wish to initiate withdrawals and simply invest their funds in the TDF closest to that year.

TDFs were introduced during the mid-1990's, as defined contribution (DC) plans replaced many defined benefit (DB) plans. Employees became responsible for selecting their own investments, but many did not have the necessary time, interest, or skills to manage an investment portfolio. Despite major investment education efforts by DC plan sponsors and vendors to turn employees into knowledgeable investors, inertia became their favorite investment strategy – select an initial asset allocation and forget it.

Until this time, investors had received the educational message about the importance of diversification by not putting all of their "eggs in one basket." However, the TDF strategy is broad diversification within one option, so investment education had to evolve to accommodate this product.

Since the U.S. stock markets were on an upward trajectory in the late-1990's, investors found success with almost any allocation strategy. When the markets dropped double-digits for three straight years ending in 2002, many of these same investors realized that they did not have a long-term investment strategy to deal with both market ups and downs. TDFs were in place to fill this void, and began to see larger acceptance and higher asset levels.

Another benefit to TDFs came with the passage of the Pension Protect Act (PPA) of 2006. Until that time, plan sponsors feared liability for setting a default investment option for their employees. The PPA insulates plan ERISA fiduciaries from liability associated with using an approved qualified default investment alternative (QDIA). The three approved categories for a QDIA include a lifecycle or target date fund, a balanced fund, and a managed account. According to a 2013 report published by Vanguard, nine out of every 10 plans administered by Vanguard with automatic enrollment use a target date fund as the QDIA[1].

While many investors have unique financial situations, the target date strategy assumes that the further you are from your retirement date, the more risk an investor can accept in his or her portfolio, since they have more time to recover. As an investor nears their retirement date, their portfolio should be more conservatively invested to maintain principal. Investment providers and plan sponsors have repeated this simple message over the years, so now the TDF strategy is palatable.

Differentiation of TDFs

TDF Glide Path

The long-term investment strategy of a TDF is based on holding a mix of stocks, bonds and other investments and is often referred to as an asset allocation. As the target date approaches, the asset allocation becomes more conservative, gradually switching from more high risk investments such as stocks to lower risk investments such as bonds and cash instruments. The shift in asset allocation over time is known as the glide path.

"To" or "Through" Retirement Glide Path

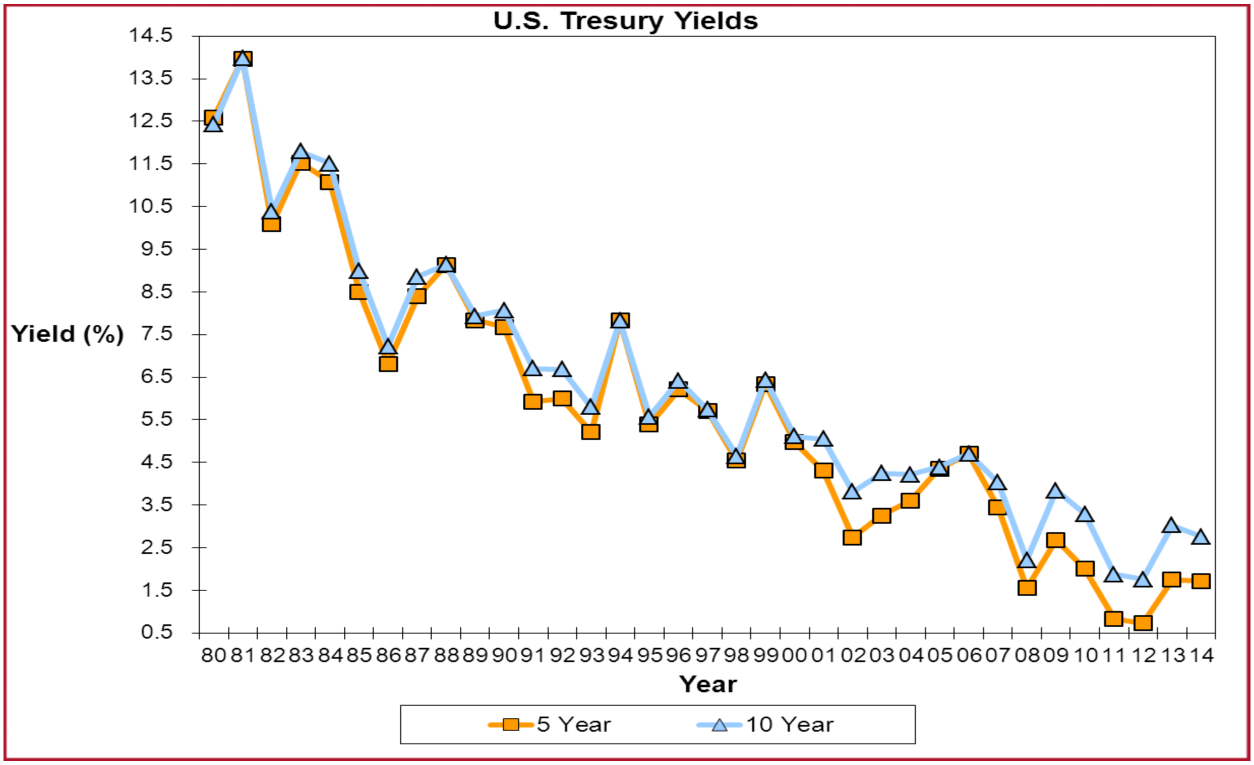
In the target date market, the fund groups that are identified or managed as "to retirement" typically are more conservative in nature before the retirement years compared to those fund groups that are managed "through retirement". To be more specific, those fund groups with the "to" glide path assume that retirement is the actual target date. At the designated retirement date and going forward into retirement, the allocation to equities and the underlying investment composition remains unchanged. For those fund groups that are identified as utilizing a "through" glide path, the investment mix continues to adjust beyond the specific retirement date. Furthermore, the allocation percentage to equities continues to decrease for a period of years after retirement before eventually leveling off.

There are extremely divergent views in the industry on the subject of a "to" or "through" asset allocation. Glide paths can vary significantly from fund series to fund series. The allocation to equity prior to and past the normal retirement age of 65 is also hotly debated and can vary significantly by fund provider. A TDF's glide path may use either a "to retirement" approach where the asset allocation is most conservative at the target date or, it may use a "through retirement" approach where the asset allocation is most conservative several years after the target date. In other words, the "to retirement" funds will have smaller equity exposure post retirement. Proponents of the through glide path utilize larger equity allocations post target retirement date and claim a "to" equity allocation could underprepare the retiree for a fully funded retirement. The flip side of the argument is that high equity allocations provide too much exposure to large market events and could significantly decrease the base available for drawdown in retirement years. It's important to select a TDF Series which best matches your employee's projected horizon. For example, uniformed employees with the ability to retire early without plans to continue employment elsewhere may be better served utilizing a "to" TDF series. Conversely, plans that retain workers well into retirement may find "through" TDF series are more appropriate.

Equity and Fixed Income Correlation Risk

The two main assets classes of TDFs are equity and fixed income. As the chart below highlights, 5- and 10-year U.S. Treasury Yields as measured from 1980 through 2013 have moved from approximately 12% to the 2 – 3% range.

Source: Bloomberg – GT5 and GT10 Govt GY Mid Yield to Convention



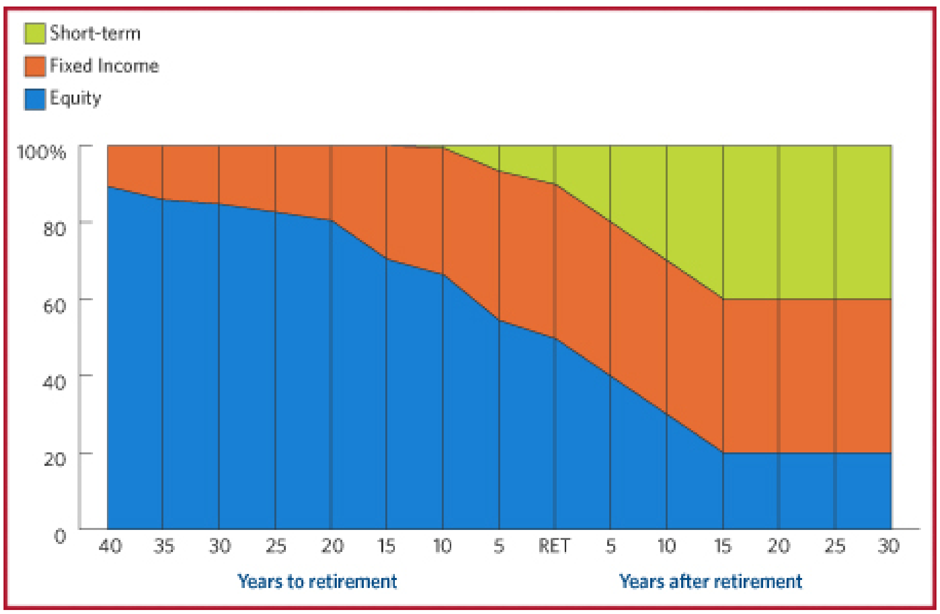
Interest rates have been on a long secular move downwards. TDFs that are structured as conservative with a "to" structure will have a higher fixed income allocation, which will dampen the effect of a large equity bear market, but will also generate more interest rate risk. Remember for each 1% rise in interest rates, the value of a bond fund will decline 1% times the investment duration. For example a bond allocation with a 5-year investment duration would lose approximately 5.00% of market value, if interest rates increased by 1%. Although TDFs and other asset allocation vehicles combine uncorrelated asset classes to dampen the losses that occur when any one asset class declines in value, due to the long term secular trend in interest rates, the capital markets may converge again (like in 2008) to produce a bear equity market with an increase in interest rates, which will cause both equities and bonds to decline in value simultaneously.

Glide Path Asset Allocation Examples

As noted above, the glide path typically focuses on the percentage of the portfolio allocated or invested in equities and will therefore reflect the declining percentage of equities in the portfolio as it approaches and passes the specific target date. Naturally, glide paths vary based on the assumptions and calculations specific fund companies utilize in designing their fund groups. However, TDF glide paths provide for a larger allocation to equities for investors further away from their target year, with a larger exposure to more conservative investments including fixed income and cash, for investors nearer to the target year, and who may be closer to retirement.

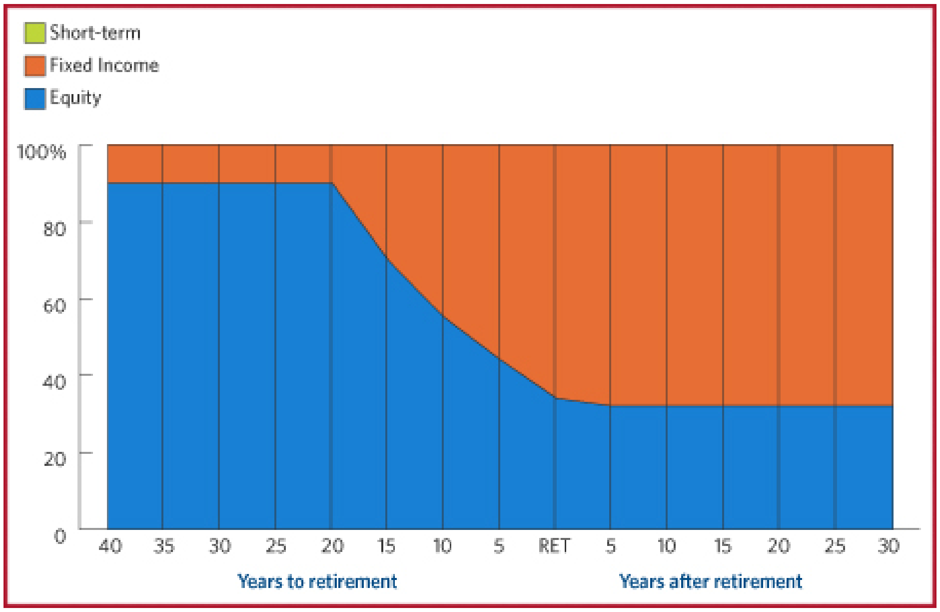
As the following example illustrations reflect, many fund groups' glide paths may continue to moderate the funds' exposure to equities after the target date is reached. In addition, there are some fund groups that actively manage asset allocations along the glide path within preset limits to respond to the current overall market conditions. While most fund groups rebalance to their original allocations annually, some fund groups are rebalancing regularly and when market conditions have skewed the allocation to the underlying funds beyond a specified tolerance.

Figure 1
Target Date Fund 1
Percentage allocation



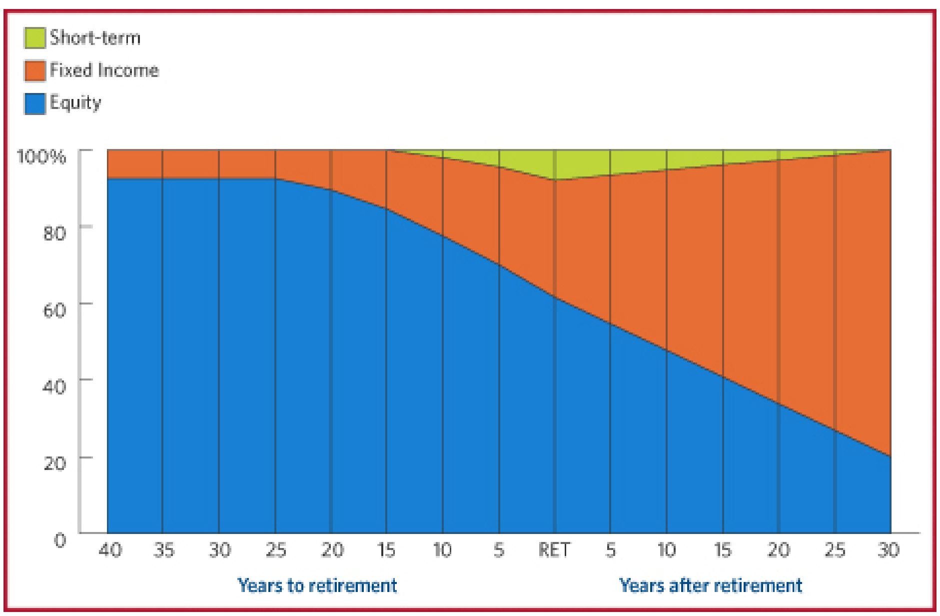
These three figures illustrate different "glide paths" for the asset allocation of different target date funds. This example allocates 50 percent of the assets to equities as of the target date ("RET") and reaches the most conservative allocation (20 percent equity) 15 years later.

Figure 2
Target Date Fund 2
Percentage allocation



This target date fund has one-third of its assets in equity as of the target date ("RET") and reaches its most conservative allocation (32 percent equity) five years after retirement.

Figure 3
Target Date Fund 3
Percentage allocation



This target date fund allocates 62 percent of its assets to equity as of the target date ("RET") and follows a steadily declining glide path over the next 30 years.

Glide Path Implications

As long-term research has shown, asset allocation is one of the most important factors in long-term portfolio performance. The key advantages of target date funds is they provide age-based asset allocations professionally constructed and managed, that typically become more conservative over time. These funds avoid the usual extremes in asset allocation that can be observed whereby some young workers allocate all of their contributions to fixed income investments, while some participants near retirement allocate all or almost all of their accounts to equities. TDFs also address the issue of participant inertia – setting an initial asset allocation and never changing it. It is important to note that TDFs do not take into account an individual's risk tolerance or any investor's individual circumstances, including what other assets they may have, if any. With all target date fund families the concern is that the glide paths used can vary greatly. Therefore, it is important for investors in TDF groups to understand how a particular fund group intends to reach its investment objectives and what risks that fund group will undertake.

Fees

As with any investment, plan sponsors are recommended to look for fund groups that are considered low cost. In the industry, the suggestion is to consider looking for fund groups where the fees are 50 basis points (0.50 percent) or less although the 50 basis point threshold may eliminate many TDF series. However, TDF providers are being forced to gradually lower costs due to pressure from lawmakers to shed more light on fees in general including target-date fund fees. In addition, consumers are more aware of the impact of fees, and this growing consumer awareness of the impact of fees on their overall return erosion is forcing fund families to gradually lower costs. As such, Morningstar has noted that the average expense ratio has declined to 91 basis points (0.91 percent) of assets in 2012 from 104 basis points (1.04 percent) in 2008. Moreover, financial analytics firm BrightScope reported that the average institutional share class target-date fund expense ratio at year-end 2012 was 70 basis points (0.70 percent).

T D F Investment Strategy (Active vs. Passive)

Different fund groups can follow different asset management approaches. While some invest all their assets into actively managed funds, other groups invest in index funds. In addition, some use a mix of index and active funds. In an actively managed fund, the theory is that the fund manager(s) uses analytical research and their own experience to build a portfolio of individual stocks or bonds. The belief is that actively managed funds may provide returns above the performance of the overall market, although there is also the chance that they may also underperform.

In an index or passive strategy, the manager sets out to track the performance of a particular benchmark, such as the Standard & Poor's 500 Index. Importantly, the expenses for index funds are generally lower than those for actively-managed funds. While index funds are designed to track the performance of the indexes they follow, generally plan participants will not meet or exceed the index performance after fees are deducted. Since they offer lower costs, index funds and other passively managed investments are growing in popularity. In 2012, Morningstar reported that more new money flowed into passively managed than actively managed target-date funds.

Proprietary/Non-Proprietary Underlying Funds

Plan sponsors typically rely on their consultants/advisors to assist with recommendations related to which family of TDFs funds to use for their employees. Some target date providers offer a pre-packaged target date group, which uses only the vendor's proprietary funds as the underlying components. However, with the advent of open architecture in the government market, there is a willingness by most providers to offer non-proprietary fund groups as alternatives.

Non-proprietary TDF groups could also offer advantages by including component funds that are managed by fund managers other than the TDF groups itself, thus diversifying plan participants' exposure to one investment provider. There are some costs and administrative tasks involved in creating a custom or non-proprietary TDF groups, and they may not be right for every plan sponsor. Generally, a custom or non-proprietary TDF group may be applicable for a plan with a minimum of approximately $250 - $300 million to invest in TDF assets.

Investment Product – Mutual Fund, Collective Investment Trust Funds and Separate Accounts)

Traditionally TDFs have utilized mutual funds as the funding vehicles, but larger plan sponsors are now considering collective investment trusts and if large enough, a separate account can be created. As background, a collective investment trust is created or administered by a bank or trust company, and like a mutual fund, it creates assets from a number of sources. Collective investment trusts do not issue formal prospectuses and are not traded on any exchanges. They are also not offered to retail investors and cannot advertise by law. However, their advantage is in the fees they charge. The fees for a collective investment trust can be as low as one-third of a similar structured mutual fund.

In addition, another benefit of collective investment trusts is that they can be structured in such a way to match the demographics of a particular plan sponsor's employees. As such, plan sponsors can work with banks and trust companies to create a TDF group that has a specific asset allocation or glide path built around its specific employee groups and coordinate with their employee-benefit package, instead of offering an off-the-shelf target-date mutual fund group. One key disadvantage to collective investment trusts is that when participants leave the plan sponsor, they cannot rollover the collective trusts to an IRA. Individual have to sell their collective investment trusts and then rollover the cash.

Cost effectiveness of Custom TDFs

An alternative to standard target date fund groups are "custom" TDF groups that may offer advantages to a plan sponsor's plan participants by providing the plan sponsor the ability to incorporate the plan's existing core funds in the TDF options. There have been concerns expressed by industry experts regarding the use of pre-packaged TDF families which are outside a comprehensive selection process. As we noted earlier, the lack of uniformity can make these fund groups challenging to understand, monitor, compare to each other or even compare to a benchmark. With these factors in mind, there is the belief that using a custom target-date solution may help address those challenges. In the industry, more than half of consultants/advisors (51%) believe a custom target-date approach is an improvement over the current proprietary/non-proprietary fund groups, according to a 2013 PIMCO survey. For plan sponsors, selecting a custom target-date solution can help avoid being locked in to one fund manager for all underlying components of the TDFs. In addition, a custom approach allows consultants/advisors to leverage the plan sponsor's core investment options, which they have selected as a "best in breed" line up. There is also the ability to further diversify the TDF by including non-traditional investment options such as emerging markets, commodities, REITS, TIPs, etc.

There is continued debate about whether a standard TDF group approach or a custom target-date solution increases fiduciary exposure to plan sponsors. The former could increase the risk of fiduciary exposure in the absence of a prudent, thoughtful and well-documented process. From an opposite perspective, a custom fund approach will require greater plan sponsor involvement with more intricate decisions needed and the added costs of developing the glidepath and selecting and monitoring the additional funds to complete the custom series.

However, custom target-date solutions are increasingly adopted by sponsors looking to strengthen their retirement plans, and while the process is complex, the reasons behind this adaptation are simple: increased fiduciary support, more appropriate glide path, possible overall cost savings, and the desire for better participant outcomes.

Sponsor Selection Criteria for a TDF Series

A good understanding of your plan's participant demographics, investment allocation behavior and participation in other benefit programs is necessary to decide which type of TDF series could best fit your plan. The high-level decision points are a glide path of "to" or "through" and whether the underlying funds are actively managed or index based.

The ability to generate an income in retirement close to the income being achieved while active in the workforce is a good indicator of the success of a retirement program. The industry often uses "replacement ratio" to measure the success of a benefits program. What is the overall salary replacement ratio (expressed as a percent of salary while working) required to support the participant's lifestyle in retirement?

A common target replacement ratio could be in the 75% - 85% range. If the participant is covered by a defined benefit plan and has paid into social security, it's possible to solve for what the participant would need to save within their 457 deferred compensation plan to augment their defined benefit and social security benefits to generate the target replacement ratio.

From a replacement ratio perspective, Plans whose participants can count on a defined benefit and social security benefit perhaps would not need to take on the additional risk of a TDF with a "through" strategy, while plan participants that do not have access to either a defined benefit plan and/or Social Security that require more income could perhaps benefit from a "through" strategy. Another view point would be that if participants have accumulated defined benefit and social security benefits, then participants could take on additional risk with a through retirement structure to maximize their income.

Understanding Your Plan Participant Profile

What type of plan data should be reviewed to help decide which type of TDF to select? Start with participant demographics. Enlist your plan administrator to generate the following data sets to get a feel for your participant base. Group your participants by active/inactive status in 5 - 10 year increments. Obtain the average balance and asset allocation for each grouping.

- How is each age cohort invested?
  - o What is the average equity exposure for each cohort?
  - o Does the asset allocation by cohort show a risk averse or risk taking profile?
  - o or plans that already have TDFs, are participants in each cohort invested in an age appropriate TDF?
    - Special attention should be given to the profile of the groupings closer to retirement age

- Replacement Ratio/ Integration with Other Benefit Programs
  - o Are your participants covered by a defined benefit plan? If yes, has the plan's status changed? Any plans to convert the plan to cash balance/freeze?
  - o Do your employees pay into Social Security/Medicare?
  - o Do your employees have access to an employer sponsored post–retirement health benefit?

If you have already selected your TDF series, it may be beneficial to review how your participants are using the product.

Are your participants using the funds as designed?

- When used, how are TDFs being utilized?
  - Is it the sole investment option used by participants?
  - Does the TDF exposure only represent a portion of plan investments?
  - Are participants in multiple TDFs?

- Who uses TDFs?
  - What groups of participants have the highest percent of assets in TDFs?
  - Where are new contribution allocations going?
  - What is average plan and TDF balance of employees nearing retirement age?

Current Industry Trends of the last 5 years (2008 through 2013)

Trends In Net Flows

In 2012, net inflows to the 2016-2030 cohorts garnered the most net cashflow. Longer dated funds saw significantly smaller inflows with the 2000 – 2010 grouping showing a small net negative flow. A possible explanation could be that middle-aged investors who would be investing in the 2016 – 2030 groupings have higher salaries, are more focused on accumulation because they are closer to their retirement age, and have the most to gain from a tax perspective (in the current year) by deferring a larger percent of salary. Deposits to longer dated funds are most likely younger employees who have lower salaries and less sense of urgency to contribute a high percentage of their salary. Finally, the near term TDFs are perhaps experiencing outflows due to normal de-accumulation from retirees.

Based on Morningstar's 2013 asset flow for mutual fund data (excludes collective investment trust and custom target date funds), TDFs took in approximately $51 billion in net new assets, bringing the industry's total net assets of approximately $621 billion. Net flows have averaged $48 billion annually for the past five years[2].

Shift To Passive TDFs

In 2012, for the first time, allocations to passive TDFs exceeded flows to active TDFs. At year-end 2013, one third of the industry's assets were in passive funds as compared to 24% five years ago. Vanguard TDFs have been responsible for the majority of this growth, taking in $18 billion in 2013, more than double of any other TDF series. The industry is paying attention. Some fund families have introduced passive investments in one form or another either by implementing a standalone passive TDF series or including index funds within their active TDF series. Lower fees and a less complex product structure are most likely the main reasons passive funds continue to gain in popularity. Concerns regarding underperformance of actively managed funds that comprise an active TDF series can be allayed by the utilization of passive TDFs.

Top 3 Players Market Share

The top 3 players in the TDF space are Fidelity, Vanguard and T. Rowe Price. Having an established brand name in the mutual fund and defined contribution space and having a product for sale early in the launch of TDFs helped establish the base for these firms. At the end of 2013, these firms had an approximate 75% market share although the share of market between the families has changed. Fidelity dropped to a 30% share from 39% five years ago, Vanguard increased to 27% versus 22% over the same period and T. Rowe's remained flat at 17%. In 2006, the top 3 share was 83% which seems to imply that as other fund families offerings become more established, the share of the top 3 may continue to shrink.

2013 TDF Performance

Funds with smaller exposures to TIPs, REITS, commodities, emerging market equities and investment grade bonds more than likely outperformed their respective TDF peers due to the these sectors performance in 2013. A high allocation to US equity likely propelled a fund series towards the top tier of their peer benchmark. While a large U.S. equity allocation was a significant contributor to outsize returns in 2013, it makes more sense to look at performance of a series over longer periods and full market cycles.

In 2013, the landscape of TDF offerings continued to grow. Morningstar is now tracking 51 unique TDF series with at least a one-year track record. Given the large number of series available to plan sponsors today, it can be difficult to differentiate one from another. For example, T. Rowe Price, which has managed a series of target-date funds since 2002, launched a second series, the T. Rowe Price Target Retirement Funds. The new series is intended for investors desiring less market exposure at their retirement date than the existing series. At 10 years prior to the target date, the equity allocation of these funds will have 15% less equity exposure then the T. Rowe's flagship TDF series glide path.

A few other target-date series entered the market during the year as well. These offerings included a continued shift of TDF providers that previously offered TDFs in 10-year increments adding new funds in five-year increments.

Monitoring and Benchmarking TDFs

As TDFs gain more of a track record and popularity, more firms and investment consultants are stepping up to provide data and benchmarking services. One firm recently launched evaluation software that provides fund family recommendations based on a proprietary derived "risk score" based on a short questionnaire. Below are descriptions of some of the firms that provide these services.

Morningstar and TDFs

Morningstar's proprietary TDF rating system evaluates each fund based on 5 criteria, they are

- *People*
- *Parent*
- *Performance*
- *Portfolio*
- *Price*

Based on the five component ratings, each TDF series earns an overall rating of either Gold, Silver, Bronze, Neutral or Negative.

Morningstar's fund family Target Date Fund Series reports provide both comprehensive qualitative and quantitative summary information for each series of TDFs.

Morningstar Allocation Lifetime Indexes

In addition to rating TDFs at the series level and each fund individually, Morningstar also maintains proprietary TDF indices. The Morningstar Lifetime Allocation Indexes are a family of multi-asset class target maturity indexes available in three risk tracks: Aggressive, Moderate, and Conservative. Each risk track consists of 13 indexes ranging from a 2055 index to an income index. The glide paths and strategic asset allocations of the indexes is based on Ibbotson's Lifetime Asset Allocation methodology. Security selection for each sub asset class in the index family is provided by a matching Morningstar market index.

Russell Target Date Metric®

The Russell Target Date Metric (TDM) was designed to measure the ability of an entire family of target date funds to achieve their primary goal of building wealth for retirement. Aspects of a fund family's investment process are captured in the metric including active management, asset allocation to equity and fixed income, and the assumption of cash contributions towards retirement.

The TDM benchmark glide path's returns are generated by weighting the returns of a static allocation consisting of 40% Russell 3000, 20% Russell Global ex-US Index and 40% Barclays capital U.S. Aggregate Bond Index. TDM scores a family of funds based on their return comparison to this static allocation. An overall score of 100 is assigned to the benchmark. A fund family is assigned a performance rating score expressed either above or below the benchmark of 100 and can be compared to other fund families.

While the tool allows one to compare fund family performance relative to a static benchmark and evaluate multiple fund families relative to each other, that static comparison benchmark may be considered too simplistic to adequately evaluate the risk, reward trade off and underlying composition of the each family of funds.

S&P Target Date Scorecard

The S&P Target Date Scorecard provides performance comparisons, equal- and asset-weighted category averages, and analytics covering the TDF universe. S&P separately tracks performance of the "Through" and "To" glide path categories. Underlying data is obtained from the Morningstar® U.S. Open-end Fund Database. The S&P Target Date Scorecard is published semiannually.

Both the "To" and "Through" indices are built by averaging the universe of returns of similar funds (5 year TDF increments). The S&P Target Date Scorecard can be used to compare a fund's glide path and performance against the average of peers in a similar fund.

BlackRock TDF Edge Evaluator
The BlackRock TDF Edge Evaluator (the "Evaluator") is a fairly new tool developed to assist plan sponsors and their advisors objectively compare TDFs by focusing on a number of categories that help to identify the TDF series that may best fit participants' needs and plan sponsor preferences.

An Evaluator user can select up to four TDF series from the list of TDF series included in Morningstar's database and has the option to complete the Target Date Fund Questionnaire (the "Questionnaire").

The Evaluator generates a detailed report (the "TDF Edge Evaluator Report") that compares the selected TDF series using the following categories: (i) TDF Manager Organization,(ii) Investment Objective, (iii) Glide Path Glide path , (iv) Asset Allocation, (v) Implementation, (vi) Expense Ratio, and (vii) Performance.

If the user elects to complete the Questionnaire, the report will also generate a summary comparison of target date fund series, based on the user's answers to specific questions regarding two of the most critical components of any target date fund series: (a) Investment Objective and (b) Glide Path. If a user elects to complete the Questionnaire, these two "Summary" pages (the "Questionnaire Output") would be included as the first two pages of the TDF Edge Evaluator Report.

The BlackRock TDF Edge Evaluator provides very clear graphics that provide a comparison of up to 4 fund families with the usual set of criteria including glide path, asset allocation, equity allocation at retirement, performance and fees. The tool goes a little deeper and estimates the impact of +20/-20% equity market swings for each series and using each series retirement equity allocation, shows the portfolio level return impact of 1) a 200 basis point increase in the 10 year US Treasury rate and 2) a 2.00% increase in inflation.

Regulatory Environment in the Target-Date Fund Universe
In early 2013, The US Department of Labor (DOL) released guidance to assist plan sponsors with the selection and monitoring of TDFs in participant-directed individual account plans subject to ERISA. [3] Although governmental plans are not subject to ERISA, best practices derived from guidance on ERISA topics are always a bright path to follow if the subject is generally applicable to DC plans regardless of the plan's Internal Revenue Code.

The report stated that the main variables of TDFs to consider are investment strategies (conservative, moderate and aggressive), glide path (to or through retirement) and investment–related fees.

In addition to the suggestion that plans assess the suitability of a custom TDF versus a retail fund, or "off-the-shelf" (proprietary) option, the publication's tips emphasized assessing the various target-date options and whether their attributes align with the demographics of the plan participants. They also discuss establishing a process to review and understand the funds, the glide path, fees and expenses, and developing effective employee communications.

The publication included the following recommendations:

Establish a process for comparing and selecting TDFs – Plan fiduciaries should develop an objective process for gathering information to enable them to evaluate the prudence of any investment option under the plan.

EBSA suggests that plan fiduciaries consider prospectus information, such as information about performance and investment fees and expenses.

Establish a process for periodic review of the plan's TDFs – Fiduciaries are required to periodically review the investment options offered under their plan to determine if any changes are needed. If there are any significant changes to the fund or the plan's objectives the fiduciary may need to consider replacing the fund.

Understand the TDF's investments – The allocation in different asset classes (stocks, bonds, cash), will change over time. Since some TDFs have a glide path that is most conservative after the target date and others have glide paths that are most conservative at the target date. It is very important for participants to understand the glide path to determine if the TDF is a good fit for them.

Review the fund's fees and investment expenses – TDF fees and costs can vary in amount and type of fees and even small differences can have a significant impact on reducing long-term savings.

Inquire about whether a custom or non-proprietary TDF would be a better fit for your plan – Some TDF providers may offer a pre-packaged product using only the vendor's proprietary funds as the TDF component investments. EBSA suggests that the plan fiduciary consider a custom TDF that incorporates the plan's existing funds or a nonproprietary TDF where component funds are managed by fund managers other than the TDF provider. These options can be discussed with the plan's investment provider.

Develop effective employee communications – Participants who are directing the investment of their own assets under the plan need the same type of information the plan fiduciary does to make appropriate investment decisions. Some of this information is provided in the disclosures required under the DOL Participant Fee Disclosure regulations that became effective in 2012 (see QPN 2011-2).

Take advantage of available sources of information to evaluate the TDF and recommendations you receive regarding the TDF selection – According to EBSA there are an increasing number of commercially available sources for information and services to assist plan fiduciaries in their decision-making and review process, however no specific sources were named in the guidance.

Document the process – Plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options.

In April 2013, the SEC's Investment Advisory Committee published a set of five recommended revisions on their 2010 proposed rule on marketing and advertising TDFs. The published report also included guidelines that defined contribution/ deferred compensation plan consultants and plan fiduciaries should consider when deciding which TDFs (including the decision to offer a custom solution) to include on their plan menu. Among them were recommendations to include an alternative glide path illustration based on the target risk level over the life of the fund that could also be used for side-by-side comparisons of TDF risks, as well as a requirement for prospectus disclosures for clear explanation of policies and assumptions used to design and manage the funds. Suggestions also included warnings that the TDF is not guaranteed and has the potential for losses, and clearer fee disclosure requirements on the estimated impact of fees over the entire holding period of a TDF.

A final ruling on the advertising and marketing of TDFs is expected to be published by the SEC in the fall of 2014.

Other TDF Topics To Consider

How does a Advice Provider program fit with TDFs?

TDFs are not compatible with advice providers and managed account programs. Advice providers typically exclude TDFs from their asset allocation models, because both programs are basically trying to accomplish a similar objective. One is using a single fund that glides the allocation through the participant's lifetime, the former is continually re-balancing investment in the plan's own investment options to match a pre-determined allocation based on age and risk tolerance as the participant ages.

What are the participant "watch outs" in regards to TDFs?

Studies have shown that some participants may be missing the point regarding selection of a single TDF that best approximates their retirement age by investing more than one TDF. If your plan contains this phenomenon, perhaps a special educational insert dedicated to the multiple TDF investors to reinforce the single usage concept.

Another watch out is the topic of a TDF guarantee. Although TDFs are beginning to be used as the underlying investments in some plan retirement income vehicles, it's important to set expectations and reinforce to TDF participants that their investment in TDFs does not contain any principal guarantee. As we saw in 2008, it's possible to lose money by investing in a TDF.

Access To TDF Providers on Recordkeeping Platforms

As mentioned above, the number of providers and flavors of TDFs has steadily increased. Morningstar now tracks over 51 separate TDF series. Access to some of the newer and less established TDF series may be limited by your plan's administrator's platform. Some plan administrators only feature their own proprietary funds, some have a limited menu of choices and still more feature open architecture and can accommodate many choices including custom TDFs.

Who is managing the underlying funds of a TDF?

TDFs can be either "closed" or managed entirely in-house or "open" meaning there is some strategic mix of in-house and external managers. Some of the larger players in the TDF space have traditionally managed the underlying assets in-house. Logic says that an open architecture TDF will produce superior investment results due to the selection of best of class funds in all sectors. It's not likely that a fund family sponsoring an active "closed" fund has best of class funds in all sectors represented in their TDF series. The exception would be TDF series that features all passive or index funds. Since an index fund's goal is to simply reproduce a benchmark index return, the best in class is less important."

Tinkering With Glide path – Asset Allocation

Some providers have made strategic changes to their TDF series, changes were made in response to the capital market downturn post 2008 and continue to be made as providers re-assess their asset allocation modelling. Examples are a more or less aggressive allocation to equities and/or alteration of the series glide path. Sponsors that utilize these funds should re-assess whether the change is a match for their participant base.

Ongoing Monitoring

Like any other plan investment option, TDFs should continually be evaluated to insure that the performance of each TDF (and the series) continues to provide the expected level of performance. Sponsors may wish to include specific TDF monitoring criteria and performance triggers in their plan's investment policy statement. Although more difficult to monitor than other easily benchmarked options, it is possible to compare a TDF Series against its peers, The most common benchmark as of this writing seems to be the Morningstar TDF Series which has data covering Conservative, Moderate, and Aggressive TDF series. Since TDF series are meant to perform over full market cycles, perhaps the measurement period for listing a series on "watch" or taking the action to replace a series should be longer than other investment options.

Conclusions (*Average use* in NAGDCA plans)

How popular are TDFs within NAGDCA Plans? We reviewed the NAGDCA member survey questions that were published in March of 2013 to verify how popular TDFs are within NAGDCA plans. Within the investment fund section of the survey results, approximately 86% of the 107 respondents identified the use of a TDF series within their plan (also known as age-based, target maturity or lifecycle funds). In addition, 53% of survey respondents identified TDFs as their plan's default option. When asked what percentage of participants utilized either Target Date Funds or Target Risk Funds – more than half stated the usage was in the 0% to 20% range. 12% responded that higher than 50% were contributing to these funds. On the topic of auto-enrollment, only 8% of plans indicated that they utilize this service. When asked why their plan did not utilize auto-enrollment, the two primary reasons cited were "not desired/needed" 47% and "state law does not allow" – 47%.

This is partially consistent with defined contribution industry observations that state the defined contribution TDF plan investment option menu penetration is high, but actual usage is low. This will change, however, as the long-term impact of QDIA and auto-enrollment continues to allocate more dollars to these funds. We say partially consistent because the lack of auto-enrollment and its companion feature auto escalation for governmental plans is perhaps slowing TDF adoption and usage by governmental plans.

Conclusion

The 2013 NAGDCA Defined Contribution Plan survey covered 136 government defined contribution plans. Of the responding plans, 82% now offer target date funds, indicating that target date funds have become mainstream and accepted as an important option within 457 plans.[4]

How will TDFs react if we experience a repeat of the 2008 capital market events? Most TDFs due to their construction will be affected by large beta market events (like 2000 and 2008). TDF exposure to asset classes that may be less correlated to US equities and bonds such as REITs, non-US equities, TIPS and commodities may help dampen capital loss. Regardless of the equity allocation, participants will experience a decline commensurate with their respective equity allocation contained within the glide path of the fund they have chosen to invest in. An equity bear market along with a rise in interest rates will cause losses for both the equity and fixed income allocations within a TDF.

TDF series with allocations to uncorrelated asset classes may dampen the overall volatility but the effectiveness of a TDF to generate adequate retirement income depends heavily upon how the markets are behaving when a participant leaves the work force and starts drawing down.

Participants separating service today should be in much better shape than in the 2008 and 2009 timeframe.

Are Target Date Funds "successful" as a retirement savings tool?

Are TDFs providing an adequate stream of dollars to fund an investor's retirement? Perhaps it is too early to declare victory or failure for TDFs, but the innovation and choices available at least allow for an intelligent matching of a TDF Series with the specific anticipated needs of the participant group.

The objective of a TDF is to generate the "right" amount of assets to produce an adequate amount of retirement income through the complete lifecycle of a retiree, which is a very difficult task due to the long time horizon and variable and unpredictable nature of the capital markets. A conservative glide path may dampen volatility, but leave the retiree short of assets in retirement. An aggressive glide path has the ability to provide a larger asset base, but may expose the participant's account to large losses with a resulting funding shortfall. Engaging the tools that allow the selection and monitoring of a TDF series with the "sweet spot" that works for the participant group would seem to be the most important task of a plan fiduciary. As assets accumulate in TDFs, active fiduciary review and selection of the appropriate TDF can and will make a positive difference in the retirement of our plan participants.

Sources:

1. http://about.bloomberglaw.com/practitioner-contributions/considerationsfor-fiduciaries-choosing-target-date-funds/

2. Fourth Quarter 2013 Ibbotson Target Date Fund Report http://corporate.morningstar. com/ib/documents/TargetMaturity/IbbotsonQ42013TargetDateReport.pdf

3 *DOL publication "Target Date Funds* – Tips for ERISA Fiduciaries" www.dol.gov/ebsa/newsroom/fsTDF.html

4. NAGDCA Defined Contribution Plan Survey Report - March 2013 http://www.nagdca.org/dnn/portals/45/documents/2013_NATIONAL_SUMMARY2302.pdf)

Further Reading:

2013 Morningstar Target-Date Research Paper http://corporate.morningstar.com/us/documents/ResearchPapers/2013TargetDate.pdf

S&P Target Date Scorecard Year-End 2013 http://www.spindices.com/documents/research/target-date-scorecard-year-end-2013.pdf

Introducing the Russell Target Date Metric TM http://www.russell.com/indexes/documents/RussellTargetDateMetric_whitepaper.pdf

Blackrock's Target Date Fund ("TDF") Edge Evaluator Methodology