NAGDCA NOTES

Target Date Funds: Does It Hit a Bull's-Eye Within Your Plan?

Target date funds, a.k.a. lifecycle, asset allocation, or age-based funds, are designed to provide a more simple investment solution for participants when choosing a portfolio whose asset allocation arrangement becomes more conservative as the target date (usually retirement) approaches. Target date funds were first introduced in the 1990's and have continued to grow in popularity among plan sponsors and vendors throughout the years. These funds are meant to enable participants to select a plan that is designed to meet their asset allocation needs over a "long time horizon," and many defined contribution plan sponsors have found them to be very useful in their overall plan.

The popularity of target date funds can be a result of some people's opinion that these funds offer participants an easy one-stop solution when selecting their investments. Many participants, whether through inertia or fear of the markets, do not rebalance their portfolios over time. Target date funds often times simplify the participants' decision making process in their asset allocations. Although the asset arrangements and allocations of target date funds vary, they include a broad range of alternatives which are designed to achieve a desired risk/return profile for the fund's investors over a relatively "long time horizon," attempting to provide a diversified investment structure similar to a traditional DB plan.

At their inception, target date funds tended to be part of a prearranged package, with an off-the-shelf approach. Over the years, target date funds have become more and more customized for individual plans. Georgette Gestely, director of New York City's Deferred Compensation Plan, said "Customized target date funds give management flexibility and more control over prices." Gestely also stated, "We have a very conservative board that likes to keep fees low, and by having the flexibility of active and passive investments, we can do that easily. We also like the ability to pick and choose our managers."

In the Pension Protection Act of 2006 (PPA), automatic enrollment is encouraged for the private sector as a way to increase participation in defined contribution plans. The Department of Labor deemed target date funds, managed accounts and balanced funds as qualified default investment alternatives (QDIA) for plans participating in automatic enrollment. Although, the PPA has no legislative governance over public plans, it can often times be used as a best practices model when state and federal statutes are not in place on certain issues.

With several target date fund options out there, it is important to take several things into consideration when selecting the one that is right for a plan. Josh Cohen, senior consultant at Russell Investments, says target date funds can not be evaluated like any other fund. Many sponsors may have to consider a different approach than they are used to. Cohen has noted the following observations:

1. **Target-date funds should be designed with specific objectives in mind.** Asset accumulation is only a part of that. "A target date fund series is not merely a set of portfolios designed for different points in someone's life. Rather, it should be seen holistically as a continuous retirement program designed to meet specific objectives," Cohen says.

2. **Glide paths slope down because of contributions, not because of time horizon.** Cohen suggests that younger investors should not be more aggressive because they have more time to make up for losses, but because they have more human capital that acts like a bond. That distinction drives fund design in many ways, he asserts.

3. **Risk should be measured in terms of not meeting retirement objectives.** "Point-in-time measurement of asset return volatility is meaningless in a 40-year savings program," Cohen says. Instead, risk should be a measure of meeting retirement goals—and, he notes that is not the same thing as running out of money.

4. **There should be high equity allocations at the beginning of the glide path.** As aforementioned, Cohen says people can afford a risky profile at the start of their savings.

5. **There should not be high equity allocations at the retirement end of the glide path.** Cohen rejects the strategy of continuing equity investments at retirement, suggesting it might work for some investors, but negative returns could be devastating. "By retirement, there are no more future contributions to offset the risk in the investment portfolio," he says.

6. **There is no clear investment rationale for the glide path to continue to slope down after retirement.** Cohen says asset allocation at retirement should be more a judge of how the investor reacts to experience than to time. So to be safe with everyone, a flat glide path is best, he says.

7. **Target-date solutions should provide diversified sources of return.** It is OK to offer volatile asset classes like REITs or emerging markets—as part of a broader portfolio (and not standalone); they make sense to offer diversification.

8. **Passive should not be considered the safe choice.** Cohen says passive investing might be good for some—but not all plans are coming to that conclusion in a way that is in the best interest of the participants.

9. **Proprietary managers face headwinds.** These managers are challenged to present objectivity and prove a best-of-breed approach, Cohen says. Plan sponsors need to evaluate themes across underlying strategies from providers, as well as the ability to gain access to capacity-constrained strategies in the target-date fund, he says.

10. **Building a custom target-date fund is harder than it sounds.** Plans looking to build a customized target-date fund need to make sure they have the appropriate staff resources, the right amount of assets to make it cost-efficient, and a solid partner—and maintain this structure for the long term.

11. **Take care with performance comparisons.** As the industry strives for more efficient ways to evaluate fund performance, Cohen says target-date funds need to be evaluated as how well the fund family builds retirement income, not as raw returns numbers from individual funds.

12. **Target date funds cannot solve all of a plan's problems.** In case sponsors and advisers have forgotten, Cohen reminds that no matter how great the target-date design, it will not solve the savings shortcomings of participants.

Plan sponsors have the fiduciary responsibility to review, analyze and monitor each investment option offered through their plan. Participants depend on their plan sponsor and administrators to provide appropriate investment options to help them to properly invest for retirement. This is a serious responsibility and one that many plan sponsors are dealing with on a daily basis. It is extremely important to be well versed in the pros and cons of introducing a target date fund into a plan. Also, be aware that these pros and cons can vary greatly based upon different aspects of each plan.

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