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The Insider's Guide to Plan Design, Administration, Funding & Compliance

How to Choose the Right Target-Date Funds for Your Retirement Plan

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Q Should a retirement plan offer target date funds as an investment option?

A Before adding a target date fund series to a plan's fund menu, the plan trustee should have an in-depth discussion with its investment advisor. The trustee should document how it arrived at the decision to use target date funds. What was the process? Did the trustee and investment advisor review the Department of Labor's guidance on target date funds and when they should be considered? A trustee should review the risk characteristics and overriding characteristics of the plan's participants with the investment advisor to make that determination.

Q What is a target date fund?

A It is a professionally managed investment vehicle offering a diversified asset allocation that becomes more conservative over time, following what is a called a "glide path." The glide path is how quickly the investments move away from equities to less risky asset classes as the target date nears. The target date is the anticipated retirement date within a range.

Q Are all target funds with a specific date similar? For example, are all 2025 target date funds similar?

A No, you would be amazed at the differences. For example, a recent study of all target date fund families found that the most aggressive fund family held 64 percent of its portfolio in equities at the targeted retirement date, while the most conservative-style fund family held only 8 percent of its portfolio in equities at retirement date. Trustees need to be aware of and understand these differences in target date fund families and choose the right series for the plan's participants.

Q How should a trustee begin its review of target date funds?

A A trustee should understand the plan and the plan participants' investment needs. The trustee needs to determine what risk the plan is trying to solve for a majority of the plan participants. For example, is this the only retirement plan offered? If there is a pension plan, this plan's investment could assume more risk. Is there above average participation rate? How high are the participant's account balances? Are there consistent employer contributions?

If you have good demographics, participants with high account balances, and high participation rates, then the risk you may want to manage is preservation of capital and protection of the account balance from a major downturn which would erode the high account balances for those 5–10 years from their target date. To manage this risk, the trustee may decide upon a fund family that uses a more conservative glide path.

If you have a plan, however, with poor demographics, low account balances, low participation, and low deferral rates, then the risk you may want to manage is that the participant accounts will not be sufficient by the target date. To manage this risk, the trustee may decide upon a fund series that uses a more aggressive glide path, to have the opportunity for a larger growth potential in the years immediately preceding the target date, with the objective to "catch-up" the account balances through investment growth.

For example, if two participants have a target retirement date of 2035, and one has a healthy account balance while the other participant has a low account balance, a single 2035 target date fund offered by the plan may not be suitable for one of these participants. The participant should know the risk profile of this target date fund. If it is conservative, it may be suitable for the participant with the healthy account balance (*i.e.*, preservation of capital), but not the participant with the low account balance (*i.e.*, opportunity for higher growth). Conversely, if the risk profile is aggressive, it may be suitable for the participant with the low account balance, but not the healthy account balance.

Understanding the plan and plan participant demographics and identifying the risk the trustee is trying to manage is really the first discussion the trustee should have with the investment advisor.

Q Once the trustee understands the plan and plan participant demographics and identifies the risks the trustee is trying to manage, what is the next step the trustee should take to review target date funds?

A The trustee should understand what target date fund families are available. In general, the longer the target date (*i.e.*, more than 30 years), the more similar the asset allocations are among the various funds. Most of these longer target date funds are largely invested in growth investments. When you review target date funds that are within 20–25 years of the target date, however, there are differences among the asset allocations in these various funds that need to be understood and reviewed. If you compare performance of several 2035 target date funds, you are not really comparing apples-to-apples, because one fund may have a 40 percent equity exposure, while another fund may have a 70 percent equity exposure. Depending upon market conditions, there may be a wide difference in performance because of the risk profile. Stated another way, a trustee should not look at a target date fund's performance without also understanding the fund's risk profile.

The trustee should also review the performance and quality of the target date fund and the fund's underlying assets. With a majority of fund families, the underlying investments are proprietary. A trustee should consider whether it wants to be locked into the proprietary funds. A trustee should consider whether the proprietary funds are of a high quality across all asset classes.

The trustee should also consider what funds, in addition to the target date funds, will be offered to plan participants. These additional offerings could supplement or provide options to participants where the proprietary funds may not be a high quality in a particular asset class. The Department of Labor also suggests that the trustee consider available alternatives to proprietary funds and document the analysis.

Of course, the trustee should also review and compare the fees and expenses of the funds.

Q What has been the industry's response to the Department of Labor's guidance on target date funds?

A In response to Department of Labor guidance on target date funds and in an effort to be innovative, a number of record keepers and platform providers offer model portfolios. This is where the investment advisor has the ability to work with the provider to develop a target date fund that is simply a model of the underlying investments in the plan. A participant selects the target date and then a model portfolio is built based upon the available investments in the plan. With these model portfolios, not only can a retirement date be selected, but also the risk profile. These model portfolios permit a more individualized choice for the participant, and give an investment advisor the ability to advise on not only the retirement date but what risk the participant should protect against.

In addition to better addressing risk, the model portfolio can address the Department of Labor's concern with a single proprietary fund because the model portfolio uses the investment choices already offered by the plan, which usually offers a fund menu comprised of several different families of funds.

However, the model portfolios have a few issues. These model portfolios typically are not unitized and cannot be transferred. They are not true funds. If the plan sponsor changes the record keeper or platform provider that offered the model portfolio, the model portfolio usually is not transferred to the new provider. In the model portfolio, you are limited to the underlying asset classes offered by the plan. For example, a plan may not offer a high-volatility asset class such as commodities or emerging markets or international real estate as an investment option because the trustee does not want a participant to solely invest in such an asset class and/or have participants chase performance. In most cases, you cannot wall off asset classes that may be good choices for the managed model portfolio, but are not good for general participant selections. Thus, many plan investment options are limited to the core asset classes. Since the model portfolio investment choices are limited to the plan investments, certain asset classes would not be available, whereas they may be an asset class in more traditional target date fund.

Q What is on the horizon for target date funds?

A In response to issues and limitations of traditional target date funds and model portfolios, there is a new generation of target date funds. These funds are true investment funds and can be unitized (transferred). These funds have an open architecture platform and can use the best funds available in each asset class. These funds offer three different glide paths based on risk profile—conservative, moderate and aggressive. These are actual, separate professionally managed funds so they are not limited to core asset classes. These funds are not available to the public, but only to retirement plans and available by certain investment professionals for their clients.

Q What should participants do if they own a traditional target date fund and are nearing retirement?

A They should look at the underlying investments in the target date fund. If it is not aggressive enough, and the participant desires more equity exposure, they could look at pushing the target date out 5–10 years beyond the retirement date. By adjusting the target date, you can address the risk concern.

Q What is the appropriate target date?

A If the risk question is answered and is addressed, then the target date is the approximate date of retirement. If the risk question is not answered or addressed, then the target date may be adjusted longer or shorter than the retirement date, based on risk tolerance (*i.e.*, longer for aggressive and shorter for conservative). By adjusting the target date you can address the risk tolerance where a fund does not provide different risk portfolios.

Q Is a target date fund appropriate as a qualified default investment alternative (QDIA)?

A Yes, and the typical target date is age 65. Again, the trustee should check the risk profile of the target date fund. The typical QDIA is moderate.

Q In summary, what are some key takeaways for trustees to know about target date funds?

A First, understand the underlying risk of the various target date funds. There are guide paths and other tools that can assist with the risk analysis. If the plan offers model portfolios, understand the plan's investment offerings, asset classes and assets classes that may be missing.

Next, there should be an analysis of the plan's demographics, so the right target date funds, with appropriate target dates and risk portfolios are offered by the plan. This analysis should be documented and this analysis should be updated on a periodic basis.

Then, the trustee should review the target date funds offered by the plan and review if the funds offered satisfy the plan's demographics; the risk concerns of the plan participants. This review should be documented and kept with the trustee's records. The trustee should review this information alongside the plan's investment policy statement and update the investment policy statement as needed.

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