Just out of Reish

Targeting Date Funds

What you need to know about TDFs

LAST YEAR, the DoL's ERISA Advisory Council issued a report on target-date funds, or TDFs. The Advisory Council emphasized the importance of fiduciaries performing their oversight functions by noting that "[i]t is estimated that, in the near future, 'between fifty and sixty percent' of all plan assets held in individual account plans will be invested in TDFs."

The report commented that many fiduciaries may not be aware of their duties or how to fulfill them, and in discussing the fiduciary responsibilities for selecting target-date funds, the report noted:

"One common theme among witnesses was the importance of analyzing a Fund's glide path. Mr. Doyle [of the DoL] expressed his opinion that plan fiduciaries, when evaluating TDFs, must analyze: the 'glide path,' the rate at which the fund shifts its investment portfolio to reduce market risks, taking into account the plan's demographics; the ability of the investment to alter the 'glide path' on a post-investment basis and the extent to which notice will be provided to the investor; the portfolio of the funds in which the participants will be invested; the historical returns, recognizing the target-date funds are relatively new types of investments and comparisons may be difficult; and the fees attendant to the investment."

As the quoted language suggests, the most important criterion is the "glide path." A TDF's glide path consists of (1) its asset allocation and (2) the process by which the allocation grows more conservative as the fund approaches its target date. (The "asset allocation" is, simply stated, the percentages that the TDF invests in different types of assets, like stocks, bonds, real estate, cash, and so on.)

It is not enough to analyze those factors in isolation. Instead, fiduciaries need to benchmark them against peer group averages.

While it may be inappropriate to compare a target-date fund family against an average of all target-date funds, the investment community is developing a series of benchmarks that can be helpful and that can reflect, at least to a degree, the character of a particular target-date family. That would include, for example, data published by Target Date Analytics, Morningstar, Dow Jones, and Standard & Poors. (When I talk about the character of the target-date fund family, I am considering, among other things, whether the fund family is designed to be aggressive or conservative—to maximize the potential for return and, therefore, the risk of loss, or to minimize the risk of loss, but give up some potential return.)

In evaluating the glide path, fiduciaries should establish their objectives and then select a target-date family that is designed to meet those goals. Should you be more concerned about appreciation or preservation? This approach was described by Turnstone Advisory Group in its second in-depth analysis of TDFs:

"It is in the glide path where we see the most fundamental differences between fund families. For instance, do the managers believe their job is to boost retirement account balances through aggressive growth strategies, or do they believe their job is more accurately stated by the Hippocratic paraphrase, 'First, lose no money'?"

A consensus is emerging that fiduciaries should focus primarily on the asset allocation over the 10 years approaching retirement. At this point, that would be the 2010, 2015, and 2020 funds. After all, that is where stock market volatility—whether up or down—has the greatest impact on participants' benefits. Unfortunately, there are few services to help fiduciaries and their advisers evaluate these differences.

In the final analysis, the worst fiduciary "sin" is to fail to engage in this process—a nonexistent process cannot be a prudent process. For target-date funds, that process should include the asset allocations and glide paths—particularly over the last 10 years—and the needs of the participants.

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