Complexity of Design

Targeting target-date funds

TARGET-DATE funds (TDFs) have become popular with plan sponsors both as investments for participant direction and as default investments (QDIAs). However, they may have become popular before plan sponsors and their advisers were fully equipped to rigorously evaluate them.

However, plan sponsors now are expected to apply the same process to target-date funds that they apply to other investments. Because of the complexity of the design of TDFs, that job is more difficult than with traditional investments.

The American Benefits Council (ABC)—a group of large plan sponsors—and the Investment Company Institute (ICI)—a trade association for mutual funds—provided the Department of Labor (DoL) with "a tool to assist fiduciaries of defined contribution plans with the selection and monitoring of target-date funds." The ABC and ICI describe the tool as "a list of potential items for fiduciaries to consider when selecting and monitoring TDFs."

While the full list is too long for this article, I want to highlight several of the issues it raises for plan committees to consider.

What asset classes are used in the TDF to achieve diversification? Comment: DoL and SEC guidance focus on the asset allocation of TDFs. Fiduciaries should learn from that. Is the asset allocation—whether conservative or aggressive—appropriate for the covered workforce?

What is the glide path used by the TDF? What is the asset allocation at the target retirement date? At what point in time does the glide path reach its final asset allocation? Comment: The glide path is how the asset allocation becomes more conservative as the participant approaches the "target" age (and perhaps thereafter). As a result, this is a part of understanding and evaluating the asset allocation.

What is the TDF's objective and what are the asset class, asset allocation and glide path assumptions and methodologies reflected in the TDF? Are these consistent with the plan fiduciary's objectives? Comment: In developing TDFs, the managers make certain assumptions about the behavior of the participants. Are those assumptions consistent with the actual experience of your plan?

What has been the investment performance not only of the TDF but also of its component investments? Comment: TDFs should be compared to appropriate peer group benchmarks. In addition, the funds inside a TDF should be benchmarked against their peer groups, and evaluated. That is because the performance of the TDF is a function both of its asset allocation and of the performance of the underlying investments.

Will plan participant demographics or preferences be considered in evaluating a TDF's asset classes, asset allocation and/or glide path? Comment: In selecting and monitoring investments, fiduciaries must consider the needs and abilities of the participants, that is, the demographics of the workforce. For example, a less-educated and less-sophisticated workforce might suggest a conservative asset allocation and glide path, since they may be frightened by volatility and may be significantly disadvantaged by large investment losses.

There is a lack of formal guidance about the factors to be considered in evaluating TDFs. However, the ABC and ICI are organizations with expertise about TDF issues and, as a result, this is a good starting point. In addition to the criteria on this list, fiduciaries should compare their TDF family to others available in the marketplace. The DoL has made that clear in the preamble to its QDIA regulation.

Equipped with this information, fiduciaries will be in a good position to prudently review their TDFs.

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