USI CONSULTING GROUP

Target Date Funds & Qualified Default Investment Alternatives

Target Date Funds offer a single product structure that automatically diversifies, adjusts and rebalances retirement savings allocations over a long period of time. Introduced in 1994, Target Date Funds have grown both as a percentage of plan assets, as well as in importance over the last several years, in large part due to the passing of the Pension Protection Act of 2006, which named target date funds as one of several eligible qualified default investment alternatives ("QDIA"). The number of plans offering target date funds has grown substantially, rising from 57% in 2006 to 91% in 2018. In 2017, 85.2% of plans use a target date fund as their default for non-participant directed monies, generally in line with prior years. (source: 2018 Callan Defined Contribution Survey). Moreover, asset growth has been significant – from $100 billion in 2005 to over $1.09 trillion in 2018. There are 63 asset managers in the industry who offer a target date fund ("TDFs") for use within retirement plans. These asset managers provide the retirement industry with a single diversified investment solution that is deemed suitable as a qualified default investment alternative (QDIA) by the Department of Labor, specifically the Department of Employee Benefits Security Administration. Even more important has been the increase in utilization among plan participants. Since 2006, the percentage of participants holding target date funds has more than doubled. (EBRI.org). Although partially due to the increased popularity of auto-enrollment provisions within plans, many participants have migrated towards target date funds independently. For many plans, target date funds will have a significant effect on the retirement success of plan participants.

APPROACH

Industry trends are supportive of target date funds playing an even greater role in the future. About two-thirds of 401(k) plans, covering about three-quarters of 401(k) plan participants, included target-date funds in their investment lineup at year-end 2016. At year-end 2016, 21% of the assets in the EBRI/ICI 401(k) database were invested in target-date funds and more than half of 401(k) participants in the database held target-date funds. Year-end 2016, newly hired participants, meaning participants hired within the last two years, 38 % of the account balances were invested in target date funds (EBRI.org). This suggests that target date funds continue to be the default option among new plan participants. The observed growth and a likely continuing trend of growing utilization makes it crucial that plan fiduciaries establish a process for overseeing target date fund options.

As the defined contribution retirement space continues to evolve, more and more plan sponsors are considering the benefits of custom target date funds versus the off-the-shelf versions that have dominated the defined contribution (DC) space thus far.

This topic became even more prevalent when the Department of Labor ("DOL") released its "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries" in February 2013. One tip indicated that employers and other plan fiduciaries should "inquire about whether a custom or non-proprietary target-date fund would be a better fit for your plan." Although the DOL's tips were not technically formal guidance, it seems that it prompted fiduciaries to take a closer look at the target-date funds being utilized in their plans. Plans with custom target date funds increased from 11.5% in 2013 and leveled off since to 20.7% as of the end of 2018 (Callan 2018 Defined Contribution Trends Survey).

With a standard, off-the-shelf active and passive target date fund series, the plan sponsor chooses a target date series that would be most representative based on their plan (i.e. demographics, participant behavior, income objectives, open or closed architecture, asset diversification, risk tolerance and fees). The main distinction amongst the TDF providers is the curve of the glidepath and how it reaches its terminal point. With a custom target date series, the plan sponsor has an investment solution tailored specifically for their plan with an optimal mix of underlying funds that comprise the glidepath, coupled with a reasonable cost structure.

With demographics ranging widely across defined contribution plans, selecting the appropriate target date series for participants is key. USIA has worked with current and prospective clients alike in reviewing the suitability of their current target date fund option in relation to their plan's demographics. Glidepath, underlying fund architecture, performance and fees are included in this review.

On an annual basis, we evaluate target date fund options with our clients by applying our proprietary 5P framework as well as additional glidepath considerations to each suite. Various metrics include management teams, glidepath design, open or closed architecture, active or passive, strategic and tactical allocation, absolute and risk adjusted performance relative to peers, volatility and expenses.

Glidepath design, coupled with underlying investment manager selection and performance, are key areas of focus when evaluating TDFs. The glidepath describes how a fund changes its allocation from more aggressive to more conservative investment options as the target retirement date approaches. Frequently this is illustrated by showing the change in equity and fixed income allocation that occurs as investors in the target date fund age. Each target date fund suite has an established glide path. There are two main glidepath designs - "To" or "Through" retirement. The distinction is relatively straightforward. A "to" glidepath design manages and adjusts the asset allocation to the target date. Conversely, the "through" glidepath design continues to make changes to the asset allocation after the target date is reached. Typically, through retirement date funds will continue to adjust the allocation after the retirement date has been reached, with varying terminal points depending on glidepath design. Both designs have a terminal point at which the allocation then becomes neutral in retirement.

Performance of the target date series is dependent on the success of the strategic and tactical allocation decisions of the portfolio managers as well as the strength of the underlying funds' performance in their respective asset classes on a relative and absolute basis. The ultimate success of the target date series will be if, together with solid fund performance, it achieves its respective participant's goal.

Constructing a well-diversified portfolio can be challenging, even for financial professionals, and most participants lack the desire and the knowledge to develop their own portfolio. Studies show that even if plan sponsors offer efficient investment menus, participants fail to construct efficient portfolios. This leads to the reduction of retirement wealth by 20% due to poor investment decisions. In addition, the average investor pays a penalty of 2-4% on their annual returns through trading at the wrong time. Therefore, the most effective way to address this challenge is to have these assets managed by an investment professional.

To accomplish this goal, you, as the plan sponsor, have a choice: offer an off-the shelf target date series or a custom target date series, if available. While many plan sponsors select the off-the shelf target date funds, in part due to a lack of availability of a custom option, we at USIA have created a custom target date solution, developed in partnership with risklab, designed specifically for your plan. Together, we will work to support your fiduciary role by guiding participants to their income goal while aligning the investment strategy with their respective risk tolerance, the foundation of which is based on the completion of a short questionnaire incorporating a plan level summary of employee, savings and risk characteristics. Employee characteristics include participant average age and income, income forecasted based on educational level, retirement age target, and % of participants in a QDIA. Savings characteristics include plan level participation, savings rate of typical participant (employee + employer contributions), average participant plan balance, income replacement target in retirement, Social Security benefit in future (inflated) dollars, and pension (DB) or other benefit (annual replacement %). Risk characteristics include investment knowledge, industry alignment with plan's activities, participant's ability and/or willingness to extend their retirement date and the participant population's risk tolerance near retirement.

Once the glidepath is determined, we then incorporate your plan's existing core funds in our custom glidepath which includes allocations to a broad array of asset classes to provide a diversified solution. A typical menu will include allocations to domestic large- mid- and small-cap equity; international large cap equity; diversified emerging market equities; and domestic core fixed income and alternatives (if appropriate).

As previously stated, ongoing performance monitoring at both the glidepath and underlying fund levels is conducted in line with USIA's proprietary due diligence process. Performance measurement is based on maintenance of the glidepath, underlying funds ability to meet our due diligence expectations and the persistency and consistency with which risk adjusted results are generated. Fee assessments are typically done by comparing viable options for your plan. Again, there is no absolute rule for selection; the Department of Labor has indicated that fees are only one aspect of selection so simply picking the lowest cost fund is not sufficient. Plan fiduciaries must also consider the investment risk and return, among other items.

Finally, you as the plan sponsor can select amongst an off-the-shelf or custom QDIA investment solution tailored specifically for your plan with an optimal mix of underlying funds that comprise the glidepath, coupled with a reasonable cost structure. Our qualified default investment alternative review was created to help you fulfill your obligation as a fiduciary and more importantly, help you to create a plan which is designed with your participants' interests in mind.

To learn more about USI Consulting Group's solution and strategies on qualified default investment alternatives, please contact your USICG representative.