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Use of Target Date Funds in Qualified Retirement Plans:

- *A primer, plus the questions fiduciaries should be asking*

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Due to their seemingly intuitive asset allocation process, target date funds have emerged as a dominant fixture in the 401(k) landscape in recent years. This trendy, relatively new style of mutual funds is the marketed solution to simplify the investment decision-making process for 401(k) participants often overwhelmed and confused by the number and type of investment choices.

In addition, the Pension Protection Act of 2006 (PPA) provided a boost in popularity for target date funds when it included new fiduciary protections for plan sponsors of 401(k) plans using so-called Qualified Default Investment Alternatives (QDIA). How so? Target date funds are generally considered to be an eligible QDIA choice and clearly appear to be a very popular choice among plan sponsors.

However, the dramatic market losses incurred in 2008 have caught the attention of many plan sponsors, congressional leaders, regulatory agencies and litigators, bringing to light several troublesome realities in dealing with these funds:

1. The market risks for some of these funds are very often not fully understood by investment committee members responsible for including them in the 401(k) plan as an investment choice,
2. The due diligence requirements imposed upon fiduciaries for these investment products are subject to the same selection and monitoring processes as other investments offered within a Plan, and
3. Target date funds differ dramatically from fund family to fund family in their respective approaches to product design, inclusion of underlying investment styles, asset allocation, product fees, and risk management; accordingly, investment returns vary widely as well... leaving 401(k) participants bewildered and mystified.

According to data obtained from Morningstar, Inc., the investment returns for the target date funds (series 2000 to 2010) for the trailing twelve month period ending April 30, 2009 ranged from -5.39% to a dreadful -39.58%!!



To emphasize the point that there is a genuine lack of knowledge on the topic of target date funds, PlanSponsor Magazine recently reported on a survey by Envestnet Asset Management which reveals astonishing results:

"...only 16% of survey respondents said they had heard of target-date funds prior to the survey, and 63% of those incorrectly described them."

If this is true, we surmise then that there is an even greater deficiency among fiduciaries about the requirements for selecting an investment product (a target date fund, for example) to be used as a plan's QDIA.

The point being... plan fiduciaries may not be getting the fiduciary protections they hoped for if the QDIA investment choice was not properly selected according to the requirements prescribed by the Department of Labor (DOL).

Given the growing number of target date investment products and their varied approaches to product design, a fiduciary's job has become all the more difficult.

Many plan sponsors mistakenly believe that any series of target date funds will qualify as a QDIA; simply by virtue of their investment product type. However, to satisfy their requirement, the DOL is literally looking for the evidence that responsible fiduciaries analyzed the needs and goals of the plan and its participants and, within that context, evaluated the appropriateness of a particular family of target date funds for the plan.

"Failure to investigate the needs of the plan or to ascertain the particular requirements or restrictions of a plan, and failure to invest in accordance with the best interest of plan participants... constitutes a breach of fiduciary duties imposed by ERISA." GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen

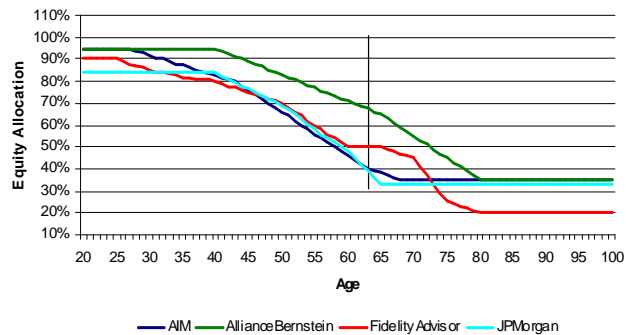
Generally speaking, fiduciaries of qualified retirement plans are liable for the investments in a plan. *This is true even in a 401(k) plan, where a plan fiduciary remains personally liable for investment decisions that plan participants make.*

For these reasons, astute plan fiduciaries seek ways to mitigate their liability by seeking fiduciary safeguards where available. Hence, it is extremely important to actually obtain the safeguards provided by the law by being knowledgeable of the fiduciary standards of care and following those rules.

What should plan sponsors know about target date funds?

The best way target date funds are understood, is to think of them as a mutual fund constructed from underlying mutual funds; diversified across many different asset classes; whose asset allocation gradually changes over time; from a higher percentage allocation to equities at younger ages, to a more conservative allocation to equities as the “target” retirement date gets closer. This graduated change in asset allocation over time is referred to as the fund’s “glide-path”. The chart illustrates what a “typical” glide-path looks like from a couple of different fund families. Notice how the approach to glide-path construction can vary significantly between different fund families.

Sample Glide Paths



Why this is only the tip of the iceberg & the devil is in the details?

The proceeding *general* description establishes a broad framework for target date fund mechanics. However, as we have shown above, since the equity allocation for target date funds can differ so greatly between fund families, this directly leads to huge differences in expected (and actual) risk and return characteristics. Notice in the chart, for example, that some fund families have an equity allocation at age 65 (the “target year”) hovering around 70% while others maintain equity allocations closer to 30%.

The product design characteristics that astute fiduciaries should be mindful of during the target date evaluation and selection process should include the glide-path construction and the underlying investment diversification structure.

Specifically with respect to the glide-path construction, fiduciaries should identify and compare each prospective fund’s investment mix at specific points along the respective glide-paths, including: 1) the furthest point from the target date, 2) at the target date, and 3) after the target date until the asset allocation reaches its “landing spot”.

In regards to investment diversification, the quality of the underlying funds and the diversification among differing asset classes and investment styles should be evaluated and considered. Some mutual fund families exclusively use their own proprietary funds, while others may utilize a more “open architecture” approach.



How can mutual fund families be so different from each other?

Believe it or not, it all comes down to risk management philosophy.

Plan fiduciaries need to determine if the applicable fund family's risk management philosophy matches their own assessment of how well such a philosophy will work for the benefit of their own plan participants.

Fund families using more equity-oriented glide-paths believe that "longevity risk", or the risk of participants simply outliving their retirement fund, is the greatest risk faced by investors. They feel strongly that longer life expectations mean there is a high probability that one of the two people in a marriage relationship will live to be age 90. Their strategy then is to design glide-paths more heavily weighted towards equities in order to continue to grow assets *beyond* the target year and overcome inflation. These glide-paths often do not find their final "landing spot" until as much as 30 years past the target date. Needless to say, these funds fared the poorest recently exposing investors with the shortest time horizons to the greatest market losses.

Fund families designing more "conservative" glide paths focus more on *protecting* investors' assets and typically have their "landing spot" much sooner than the more equity-oriented glide-paths. While growth of assets up to and beyond the target date are important; those fund families in the "conservative" glide-path camp, strongly hold the view that an unexpected capital loss due to market upheaval at an inopportune time, such as in your early sixties, as devastating and potentially non-recoverable. They rely less upon equities to provide market growth of assets to make up for employees not saving enough in the first place. Prior to the market crash in 2008 and 2009, these funds typically lagged most of their peers who benefitted from higher equity allocations.

Are all diversifying asset classes good?

Within any target date fund, there are a number of underlying funds. What asset classes do they represent? Are they proprietary funds? Are they actively or passively managed? Are they good quality funds in their own right?

401(k) plans tend to have "core" asset classes; cash equivalents, U.S. Bonds, U.S. Equities, and Non-U.S. Equities. Some plans have gone a step further; adding investment options in more specialized asset classes like high-yield debt, international bonds, real estate, or emerging markets. Fiduciaries carefully consider whether these asset classes are appropriate for their employees before adding them to the plan. Shouldn't the same consideration be given to what investment classes and styles are actually included in a target date fund?



Many fund families that offer target date funds populate their product with their own underlying mutual funds. This practice seems very commonplace and our belief is that, in such situations, fiduciaries need to pay close attention.

First, most mutual funds families tend to have centralized investment research groups and preferred philosophies and investment themes. Thus, portfolio managers and mutual funds, *even in different asset classes*, tend to overlap ideas and therefore, may not produce as much diversity of investments as you might expect. Furthermore, though there is no researched basis for this, it appears that new or badly performing funds are often included in target date funds as a way to gather assets to “jump-start” a new fund or to handle the capacity restraints of the larger, more established, successful funds in the same family and style.

Now that there's a lot more information in front of us, how do we decide?

At PrimeTRUST Advisors, we believe any prudent investment selection process must synchronize the risk and needs of its intended investors with the investment alternatives available. To do so, plan sponsors and fiduciaries should consider a wide range of employee behaviors including investment expertise, risk tolerance, savings patterns, and investment activity. One of the great benefits of such diversity among target date funds is that there is likely a target date family that is right for your company and its employees. Please do your proper due diligence on your target date fund options, or consider hiring someone to help you with the prudent evaluation.