Oversimplification in Target Date Funds Endangers Participants' Retirement Savings

How are custom solutions evolving to mitigate risk?

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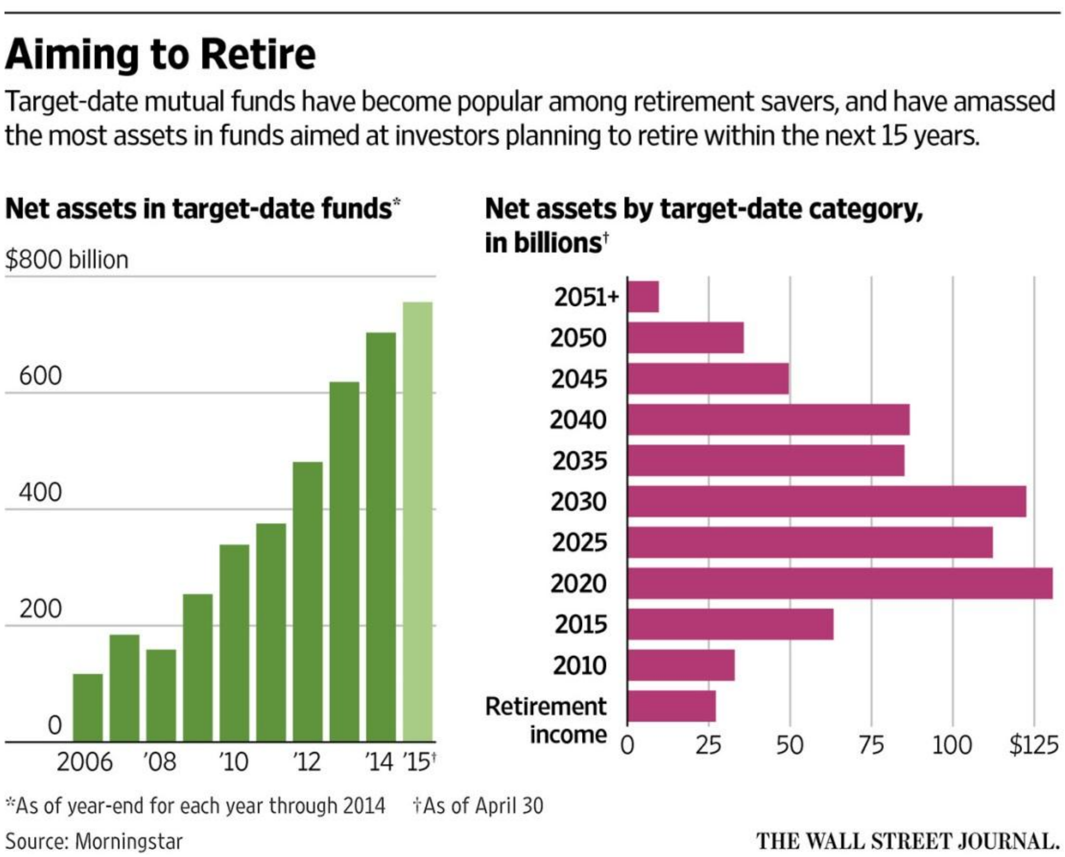
Introduction

Since the Pension Protection Act of 2006, target date funds (TDFs) have increasingly found their way into retirement plans as the preferred qualified default investment alternative (QDIA) for participants who make no election. Not only have plan sponsors widely adopted TDFs as the plan's QDIA, but participants have also gravitated to this type of fund option because of its ease of use as a "one-stop shop," allowing the selection of one fund option based on expected retirement date. A TDF diversifies and grows more conservative over time as the participant approaches the named retirement date in the fund. At present, TDFs can be found in the majority of retirement plans and are expected to increasingly become the primary if not only vehicle for most retirement plan participants.



Source: http://www.wsj.com/articles/target-date-funds-look-under-the-hood-1432921486?KEYWORDS=target+date+funds.

The simplicity of TDFs for plan sponsors and participants has been of paramount importance and a key driver for success on all levels, including adoption, utilization and regulatory compliance. But are TDFs really a "silver bullet" for plan sponsors and participants? Has the attempt to lessen certain risks in saving for retirement instead introduced new risks?

Version 1.0: Inception of TDFs

BlackRock created the first TDF in 1993. Every aspect of a TDF, from the glidepath (asset allocation) to the underlying investments, was managed by BlackRock. This single-manager, single-glidepath model is version 1.0 of the TDF. This model has seen the most growth over the past 20 plus years, as managers like BlackRock and others have built proprietary TDFs to support this fast-growing industry. Version 1.0 continues to remain the most common TDF in defined contribution plans today. One reason is the simplicity of version 1.0 TDFs. The entire investment solution is in one place, efficiently packaged. Another reason is because early on in the development of TDFs, recordkeepers typically only offered one proprietary TDF, usually their own, on their recordkeeping systems. This limited plan sponsors and participants to one glidepath and one investment manager. As the TDF industry has matured, fiduciaries and the DOL have increasingly become more concerned about the version 1.0 design because of its inherent and sometimes unseen, or misunderstood, risk to the plan sponsor and participants.

Version 1.0: Single-Glidepath Model Treats All Participants the Same

Much like the balanced fund that was created in the early 1920s, the TDF allocates investors across a percentage of stocks and bonds so that some level of diversification exists. The biggest difference between a balanced fund and a TDF is that a balanced fund will maintain a static mix, typically 60 percent stocks and 40 percent bonds, while a TDF rebalances across those asset classes over time so that the fund will have a higher percentage of bonds and other conservative-oriented investments as the retirement date approaches. Much like a balanced fund, a single glidepath has only one asset allocation policy at a given point in time.

As version 1.0 providers have multiplied, the number of glidepaths has increased as well. Interestingly, there is a stark difference among glidepath providers when it comes to asset allocation; for example, an allocation to equity at retirement varies as much as 50 percent. Because there is a lack of uniformity among TDF providers, participants in one TDF series are likely on a very different glidepath to retirement, or have a very different asset allocation, than participants in another TDF series.

It is not uncommon to find a TDF provider with 60 percent in equities at retirement and another with only 30 percent in equities. While version 1.0 TDF providers have assumptions to support their own glidepaths, the assumptions do not stop at the forecasts of stock and bond returns and risk. Assumptions also exist about the participants. The asset allocation may also be influenced by the type of investment manager: heavily focused in equities or in fixed income. For example, T. Rowe Price, a large equity manager, has one of the more aggressive glidepaths of version 1.0 TDF providers, with approximately 55 percent equity exposure at retirement. PIMCO, on the other hand, a large bond manager, has approximately 20 percent equity exposure at retirement (with a large percentage in bonds). Certainly, investment management skill and expertise in their business segments likely drive the allocation.

These large differences in equity exposure create significant variance in participants' retirement outcomes because equity risk is the primary driver of glidepath risk. To date, the message around TDFs has been that they grow more conservative over time. In this simplicity, the degree and magnitude of this shift to more conservative assets has been overlooked. Participants on different glidepaths face different risks; the biggest risk is driven by asset allocation to risk-based assets like stocks versus more conservative assets like bonds and cash.

Need for Guidance Stems from Version 1.0

The media coverage and scrutiny given to the TDF industry make it evident that glidepaths differ among TDF providers. To address these disparities, the DOL took the lead in February 2013 by providing a "Tips" sheet to highlight that TDF providers' glidepaths are in fact all different. The DOL encouraged plan sponsors to consider their plan participant demographics when selecting a TDF provider/glidepath. Participant demographics, of course, differ among plans, so the DOL acknowledged that different glidepaths were needed across different plans. Some demographics might suggest an aggressive glidepath for those participants who need greater investment return to achieve their retirement goals, while other demographics need a conservative glidepath for participants who need a consistent income stream throughout retirement. The DOL Tips also highlighted that a TDF was not as simple as once thought because plan sponsors not only need to select with adequate due diligence, but select with adequate due diligence on the appropriate TDF.

Another risk plan sponsors face is informing participants about the selected TDF / glidepath. Participants may assume the plan sponsor selected the best TDF and glidepath suited for them. Version 1.0 was not built to accommodate the individual goals and objectives unique to each participant's own retirement path but instead only addresses the needs of the median or mean participant. This message has not been clarified for participants. Participants are only as knowledgeable as the education provided by the plan sponsor; to date, version 1.0 education, information and guidance are only about the participant's expected retirement date. Version 1.0 gives all participants in a plan who retire around a certain date the same asset allocation, with no acknowledgement of individual goals, objectives, funding status or risk level.

Single Manager in Version 1.0 Creates Complications

TDF providers under version 1.0 not only determine the single glidepath or asset allocation, they also select and populate the TDF series with their own investment product. While the glidepath may be the biggest driver of retirement outcomes, it is the investment product within the TDF that typically dictates the fees paid to the provider. Plan sponsors have the fiduciary responsibility to benchmark these fees against the delivered value. The problem is not necessarily that only one manager invests the TDF's assets; rather, it is the manager's control over the assets and the lack of control by the fiduciaries. Rarely are the manager's interests aligned with the plan sponsor's interests. In cases where the plan sponsor has allowed participants to overpay for an underperforming strategy, only the manager can terminate that strategy. The plan sponsor therefore has limited recourse under version 1.0.

As more and more attention has turned to the underlying investment strategies within a TDF, more evidence suggests that plan sponsors make accommodations for underperforming investment strategies. These same underperforming investment strategies would not be options for participants if considered by the plan sponsor as a stand-alone option within the plan. Retirement Plan Advisory Group's (RPAG™) Scorecard™ research and analysis on the average fund manager show that the average manager across all asset classes scores a 6, meaning there is no identifiable skill from a quantitative perspective. Skillful investment managers scoring a 7 or higher are the exception, not the rule. Unfortunately, most version 1.0 providers have strategies scoring 6 or lower within their TDF suite, meaning most plan sponsors are paying fees to providers whose funds would be deemed unacceptable or on watch list using an investment due diligence process like the Scorecard .

Not Enough Flexibility in Version 1.0

Clearly, better fiduciary governance can be applied at the TDF level. Unfortunately, even if applied, version 1.0 allows no flexibility to fiduciaries to ensure that underperforming managers are replaced or at least independently reviewed and approved. This exposes plan sponsors to the risk of accepting underperforming investment options within the TDF. More flexibility is needed if plan sponsors are to treat TDFs the same as they do other investments offered within the plan. In version 1.0, participants are not diversified with multiple investment managers and underperforming proprietary investments likely exist within the TDF that fiduciaries cannot address without removing the entire TDF suite. Therefore, fiduciaries are presented with even greater risks.

Replacing a version 1.0 TDF suite with another may expose plan sponsors and participants to greater risks because not only do all of the underlying investments change, but the glidepath risk orientation may also change. Replacing, for example, a conservative-oriented glidepath for an aggressive-oriented glidepath because there are no other appropriate conservative glidepath options increases the risk to participants who do not understand the risk positioning of glidepaths. When plan sponsors replace a version 1.0 TDF, they may be successful in removing the underperforming investment options, however at the same time there is a risk to resetting participants on an entirely new version 1.0 glidepath. While plan sponsors have the responsibility to educate participants about the new glidepath approach, the evidence suggests that participants make little use of educational materials. In fact, many participants choose the plan sponsor's selected TDF strategy and glidepath to stay out of the investment decision.

TDF version 1.0 contains the premise that participants only have to choose their correct retirement date in order for everything else to take care of itself. However, this strategy can hurt participants, because underperformance and a single (and potentially ever-changing) glidepath pose risks to plan sponsors and participants.

Version 2.0: Introducing New Choices

As the single-manager and single-glidepath risks of version 1.0 have become more evident in the marketplace, recordkeepers have stepped up, devising solutions to help plan sponsors address these issues. This leads to TDF version 2.0, a recordkeeper solution that is customized by the plan sponsor. This approach allows plan sponsors to develop a glidepath best suited for their plan's demographics, while utilizing the underlying managers already in place. In version 2.0, plan sponsors diversify their participants' assets across a variety of investment managers, on a glidepath better suited for their participant population rather than an off-the-shelf version designed for the median or average participant. Version 2.0 glidepaths generally are a function of a plan's demographics, not the entire universe of defined contribution investors, which is one benefit of moving from a version 1.0 to a version 2.0 TDF, because version 2.0 allows fiduciaries to better identify a glidepath for their participants.

Version 2.0 Provides Flexibility to Choose a More Appropriate Glidepath

According to RPAG's TDF categorization/analysis, 50 percent of version 1.0 TDF providers offer aggressive glidepaths. This means that half of the proprietary version 1.0 providers have allocations that favor equities and risk-based assets not only during the accumulation phase but also near, at and sometimes even through retirement. With approximately 50 percent of version 1.0 TDF providers offering this aggressive solution, the challenge for plan sponsors is selecting something other than an aggressive option if what their participant population really needs is a more moderate or conservative solution. Early on, the recordkeeper constraints on TDF providers exacerbated this problem, only to be loosened somewhat over the years.

The aggressive TDF solution is still the most utilized glidepath today. This is supported by the wide body of evidence suggesting participants do not save enough for retirement. An aggressive glidepath may act as the most appropriate "catchall" for the average participant because most will need more return from their investments to make up for the general lack of retirement savings. It is no coincidence that the top three proprietary version 1.0 providers, Vanguard, T. Rowe Price and Fidelity, all run aggressive glidepaths.

For plans, however, where participant savings rates are high and/or employer contributions are generous, the landscape becomes challenging when identifying an appropriate moderate or conservative glidepath. The more conservative the plan sponsor becomes or the demographics suggest, the options dwindle and very few solutions exist. Version 2.0 allows a plan sponsor to address this, accommodating a less risky glidepath that may be more appropriate for their participants.

Manager Options in Version 2.0

At the same time the glidepath is addressed, version 2.0 allows the plan sponsor to address the managers utilized within the TDF strategy. So, while in version 2.0 a plan sponsor is not tied to an aggressive glidepath, a plan sponsor is also not tied to a single investment manager. For example, there may be an index fund that better replicates a desired index than the index fund currently being used. A plan sponsor can allocate among other types of funds or investment managers, including some strong active managers. It is not an either/or proposition.

Version 2.0 Creates Three New Problems—No Historical Performance, No Fact Sheets, and No Portability Across Recordkeepers

While version 2.0 solves some problems of version 1.0, it unfortunately also introduces three new problems. First, model portfolios do not carry historical performance, so participants cannot reference how the glidepath, or asset allocation, performed over time. Second, typically there are no fact sheets related to the models, meaning there is a lack of education and information for participants. Third, models are recordkeeper-dependent. If the plan sponsor has a recordkeeper that cannot support the model, it requires moving to an entirely new recordkeeping platform. As the plan grows, other options can be affected if the plan were to leave for another recordkeeper for fiduciary reasons. New models would again have to be built on the new platform, subject to the rules and constraints of that new platform. Therefore, the models may not look or act exactly like they did on the old recordkeeping platform.

Over the past ten years, version 2.0 has been available to plan sponsors, but despite its benefits, these three primary problems have limited the adoption of version 2.0 by plan sponsors.

Mega Plans Begin to Solve the Problems of Version 2.0 with Custom Solutions

The Department of Labor (DOL) Tips from February 2013 commented on how plan sponsors should think about selecting the appropriate TDF. One recommendation by the DOL was that plan sponsors consider the use of custom TDF approaches. This was a direct affront to the version 1.0 proprietary single-glidepath model, a model that has not changed much since 1993. The DOL recognized that TDFs could be designed to better fit plan and participant needs. The DOL also understood that outside managers could provide better options for TDFs rather than a proprietary manager. This reinforced the use of version 2.0, even with its problems.

Some sponsors of mega plans (over $5 billion) and a few large plans (over $1 billion) found a way to solve the problems of version 2.0 by adopting structures that looked like a combination of version 1.0 (fund structure) and version 2.0 (multi-manager structure). They built their own funds, separate accounts or collective investment trust (CIT) funds, and populated them with their own investment managers. Typically, a fund can cost up to $15,000 per year, meaning a suite of five TDFs could cost as much as $75,000 per year. This is one reason why small to mid-sized plans have not adopted this approach. What these mega and large plans did, however, eliminated the problems of version 2.0 because they now had historical performance for the set of custom TDFs, they had fact sheets like all of the other plan investments, and the funds were portable across recordkeepers.

Version 3.0: Increased Customization and Multiple Allocations

Custom solutions have grown significantly since the DOL's Tips in February 2013. The growth is most pronounced in the mega to large plan sponsor space. A Callan Associates study[1] indicated 22.3 percent of large plans adopted custom TDF solutions in 2014, up from 11.5 percent in 2013. An outcome of this growth has been the number of custom solutions developed and adopted by plan sponsors. Utilizing multiple managers is one of the hallmarks of this approach. As plan sponsors increasingly look at their glidepath strategy and what best fits their participant population, many find that one allocation may not be appropriate for their plan. This has led to version 3.0 and another advantage of custom TDF strategies.

Addressing Participants' Different Needs and Goals

Clear evidence appears when looking at research and studies that show participants vary in their savings patterns, specifically in how much they defer from income today. This is key to estimating a minimum level of retirement savings needed to live on in retirement. Those who would like to live more extravagantly simply need to save more than this minimum amount. A recent Vanguard study[2] examined the deferral rates for all participants on their recordkeeping platform and found the following based on the median participant deferral rate of 6 percent:

- Participants deferring less than 6 percent: 53 percent
- Participants deferring 6–10 percent: 25 percent
- Participants deferring more than 10 percent: 22 percent

A participant's savings rate is one of the largest factors to determine his or her total savings at retirement. Clearly, the assumptions to which version 1.0 providers and even version 2.0 plan sponsors have built their glidepaths do not accommodate the wide array of savings rates found within most plans. Therefore, this is the ultimate risk of TDF oversimplicity: only one assumed deferral rate. Many version 1.0 providers use what Vanguard identified as the median deferral rate, 6 percent. While plan sponsors may tweak this number to fit their demographics, this deferral rate typically does not change much because it is an average of a large population. The range of distribution is often misrepresented, which then exposes participants to the risk that they are not saving the assumed rate of deferral driving the investment solution.

Misfit Risk Is the Greatest Risk to Plan Participants

The simple, single-glidepath model that assumes participants all save at the same rate presents risks to participants' retirement savings. The single glidepath creates a misfit between what an individual participant is doing and how the glidepath is managed for the plan's entire participant population.

Misfit risk is important to understand because it ties the participant's deferral rate to the glidepath assumption. Misfit risk occurs when the glidepath does not fit the participant's actual savings rate. Plan sponsors expose their participants to this risk every time they offer or default participants into a chosen glidepath that misrepresents a known fact (no longer an assumption), which is each individual participant's deferral rate. The participant's actual savings rate is what matters.

Different Deferral Rates Require Different Glidepath Options

Misfit risk is not the same for all participants. For participants with high savings rates, misfit risk exposes them to the risk of principal and the lack of stability of income received in retirement. For participants who have low retirement savings, misfit risk exposes them to the risk that they can never achieve their retirement savings goals because the return on their investments is too low. Simply put, misfit risk is unique to each participant's funded status relative to the glidepath the plan sponsor has selected.

The Vanguard study makes evident the broad distribution of participants from a retirement savings perspective. The median participant who saves 6 percent tells little of the story. To broadly categorize participants based on their deferral rates, 53 percent are saving 6 or less percent. The best-fitting glidepath in this case is an aggressive one because most participants will not meet their retirement goals without help from the capital markets (additional investment return). For example, it is no coincidence that Vanguard's TDF strategies follow an aggressive glidepath because this is where most of the population falls, at least from a Vanguard recordkeeping perspective.

While an aggressive glidepath may meet the majority of participants' needs on Vanguard's recordkeeping system, it fails to accommodate the other two groups of participants who put away more for retirement savings. In fact, 22 percent of participants defer more than 10 percent, which is a level of retirement savings where additional risk is not necessary to accomplish retirement goals. At that level of retirement savings, the focus should be on preserving wealth at and through retirement. The misfit risk for these participants is being on an aggressive or moderate risk-based glidepath when their circumstances suggest that a conservative glidepath is the most appropriate.

Solving Misfit Risk with Multiple Glidepaths in Version 3.0

While 53 percent of participants in Vanguard's system seem to benefit from an aggressive glidepath—a key fiduciary consideration for selecting the aggressive glidepath to satisfy reasonableness of that glidepath as the plan's QDIA—the other 47 percent of the population who defer more than 6 percent are not well served by an aggressive glidepath. In fact, this 47 percent of participants are now exposed to misfit risk because better options are available for them than what is offered in an aggressive single-glidepath mandate.

Version 3.0 addresses this misfit risk by giving participants multiple risk-based glidepaths from which they can select: aggressive, moderate and conservative. In this approach, the simplicity of choosing a retirement date is replaced by choosing a retirement date and an appropriate risk-based glidepath. For example, for the retirement date of 2035, there would be three glidepaths from which a participant can select: an Aggressive 2035 fund, a Moderate 2035 fund and a Conservative 2035 fund.

Version 3.0 Adopts a CIT Structure, Alleviating Prohibitive Costs for Plan Sponsors

Until recently, the cost of maintaining more than one glidepath proved prohibitive, which is why custom TDFs have been limited to the mega and large plans (that generally still only adopt one glidepath due to costs). Three glidepaths, for example, triple the number of funds to be created and offered, versus the single-glidepath model. This brings a five-fund custom solution costing around $75,000 per year to a cost of $225,000 per year. Even for mega and large plans, this can be prohibitive. Additionally, there are investment management and administrative hurdles and complexities surrounding three glidepaths.

Version 3.0 helps address the cost issue through an old but commonly found fund structure within retirement plans: the CIT structure. This type of fund allows plans to commingle within a single trust, spreading and sharing the costs for plans. Not only can mega and large plans benefit from this type of structure, but version 3.0 allows small and mid-sized plans to participate in a custom-fund structure that had previously been out of reach from a cost perspective. The greater economies of scale also allow mega and large plans to move to a multiple glidepath model at a fraction of the cost required to maintain a custom, separate-account TDF structure.

Role of an Advisor in Version 3.0

The CIT structure also accommodates the multi-manager approach when an independent investment advisor is involved, because the advisor essentially maintains the same functions in the same manner for the CITs as were supplied to the plan as a co-fiduciary under ERISA.

The key difference in an advisor's role in version 3.0 is the manner in which an advisor will serve as co-fiduciary. Within the CIT structure, the advisor serves as a co-fiduciary under ERISA section 3(38), meaning the advisor has discretion to select and replace the underlying fund managers. Generally speaking, this is different from a 3(21) co-fiduciary role in which the advisor only gives advice. Because the trust requires direction from one party (an advisor, trustee, plan sponsor, etc.), the advisor as a 3(38) serves in this role. This is how multiple plan sponsors can access the trust and share in the advantages of this structure, including lower fees.

Version 3.0 CIT Structure Solves the Problems of Version 2.0

CITs allow the custom TDF to look and feel like mutual funds, which have been the predominant investment vehicle for retirement plans. CITs carry a performance track record, have their own fact sheets, and are portable across recordkeeping systems. Therefore, the CIT structure of version 3.0 combines the benefits of versions 1.0 and 2.0, while eliminating the misfit risk that participants accept by either selecting a TDF strategy based only on a retirement date or by being defaulted into the plan sponsor's chosen single glidepath that represents some median or average participant but not the individual's specific savings rate. At a minimum, version 3.0 presents participants with different allocation strategies, some carrying more risk than others. With education happening at the fund level in version 3.0, participants better understand that there is more to investing for retirement than just selecting a target retirement date.

Conclusion

Version 3.0 Removes the Risks of Oversimplification

The industry has desensitized and oversimplified the TDF investment strategy in versions 1.0 and 2.0, and plan sponsors and participants have de facto accepted misfit risk. This misfit risk potentially creates the greatest harm, because it is neither discussed nor contemplated in fiduciary decision making. This misfit risk will materially shape participant experiences and retirement outcomes. At a minimum, better identification and explanation are needed. Without guidance from the providers and plan sponsors, this risk remains hidden to participants as long as versions 1.0 and 2.0 are supported. Therefore, the industry needs to shift to version 3.0. There are few alternatives to mitigating misfit risk without version 3.0, unless fiduciaries begin to disclose to their participants that the selected QDIA may be the wrong one. As TDF assets grow, expected to hit $1 trillion by 2016, misfit risk will only increase until more custom solutions like version 3.0 replace the old versions.

Version 3.0 and the LDI Model: Solving for Misfit Risk

The original and elegant idea of the TDF remains intact with version 3.0. The custom version 3.0 solution, with all its complexity, is actually not a difficult solution for the plan sponsor to implement and participants to understand. The most complex decision participants must make is selecting the date they expect to retire. From there, putting participants on the right path is as easy as taking the liability driven investing (LDI) model adopted by the defined benefit industry. A participant only needs to incorporate a funding status, or deferral rate, which is an already set or known variable. With this known information, the right path is chosen for each individual participant, which is exactly how defined benefit plans manage their allocation with an LDI policy. In fact, no more information about a participant is required when incorporating an LDI model into version 3.0 than what was needed for versions 1.0 and 2.0, but now the participant is on a much better path that results in a better retirement outcome. The plan sponsor benefits from version 3.0 by addressing the individual needs of participants, leading to greater fiduciary protections because participants are offered a diversified (by risk) set of glidepaths. Version 3.0 highlights that there is not only one path to retirement; rather, multiple paths must be available for participants to fully achieve their individual retirement goals.

Disclosures

Sources:

1. "Custom TDFs: When to Use Them and Why." Napa-net.org. April 24, 2015.
2. "How America Saves." Vanguard.com. 2015.

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The target date is the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis with the asset allocation becoming more conservative as the fund nears the target retirement date.

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