New Perspectives on Target-Date Fund Selection & Monitoring

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The evolution of the target-date fund marketplace over the years has provided plan sponsors with an increasing number of options to consider. In meeting their fiduciary responsibility, sponsors should consider the following when offering a target-date product.

- Off-the-Shelf versus Custom Strategies
- “To” versus “Through” glidepath design
- Passive versus Active Strategies
- Fund Structure (proprietary versus open architecture)
- Benchmarking (proprietary benchmarks versus third-party benchmarks)

Off-the-Shelf vs. Custom Strategies

Off-the-shelf target-date funds are a one-size fits all solution. They are built using generic participant factors including: plan tenure, deferral rate, employer match, salary growth rate, post-retirement income needs and overall risk posture. When selecting an off-the-shelf solution, it is critical that the product’s factors accurately represent the plan population. The greater the alignment, the higher the probability that participants using the correct target-date fund will achieve their retirement savings goals.

It is important to note that even if there is a high degree of overlap in these factors, an off-the-shelf target-date solution will not be ideal for *all* participants – specifically late savers and those with low contribution rates. These participants are better suited to create their own custom allocation, or with the assistance of a managed account service provider.

> ***“While target-date funds are appropriate for the majority of participants, they cannot serve the needs of all participants.”***

Alternatively, plan sponsors have the option to design a custom target-date fund. Custom target-date products allow the sponsor to design and implement an approach more tailored to the needs of plan participants. Custom target-date funds are better suited for retirement plans with a common participant circumstance. The perfect example is a supplemental defined contribution plan where all participants are also participating in the sponsor’s defined benefit plan. In this case, participants already have a fixed income allocation resulting from the defined benefit plan. As such, they can assume a greater level of risk within a custom target-date solution.

Another advantage of a custom strategy is the ability to use asset classes typically not found in off-the-shelf solutions and to select managers the sponsor has the most conviction in. Most off-the-shelf target-date solutions are restricted to including only those asset classes in which the manager has a proprietary product. This may not include exposure to real asset or alternative strategies, often outside the core competency of most target-date managers, and customary in public and corporate defined benefit pension plans for decades.

It is an interesting observation that defined benefit plans take great care in selecting individual asset class specialists when constructing the portfolio, but then default to a single target-date manager, across all asset classes, for the largest pool of defined contribution plan assets. While the latter is administratively easier and often required under a "bundled" recordkeeping contract, it is becoming less common given the philosophical contradiction. This has resulted in the proliferation of model portfolios and custom products that use the defined contribution plan's own managers as target-date fund building blocks.

Custom strategies do have their considerations. They require greater administration, a key benefit of off-the-shelf solutions. This may include hiring a glidepath manager and managers in each underlying asset class. Should the product be constructed as a fund-of-funds, a custodian may also be required.

Another consideration is identifying the fiduciary for the Qualified Default Investment Alternative (QDIA), which most target-date funds serve as. Many sponsors delegate this responsibility to a third party to reduce their perceived liability. However, if the product is QDIA compliant, then there may be little additional liability. The sponsor can also achieve significant savings if it is willing to design and implement a product themselves, particularly when the cost for such services can exceed 5 bps in our experience. For a plan with $500 million in target-date assets, that equates to $250k in *first year* savings alone, capital that could be better utilized on more value-added participant tools and programs.

"To" versus "Through" glidepath design

The vast majority of target-date assets are invested in a "through" glidepath, in which the allocation to equities continues to decline post retirement, versus remaining static ("to"). This appears to be a religion of sorts within the industry. Summit's perspective is a little different. We believe the glidepath past retirement is largely irrelevant for the following reasons:

- Studies have shown that a large percentage of participants exit the plan and roll over assets upon separation[1], including retirement.
- Participants exhibit very different spending patterns in retirement based on how much they have saved, income needs, lifestyle choices, and health.
- To assume that either a "to" or "through" glidepath can adequately address so many different scenarios is overly optimistic at best.
- Given the shorter investment timeframe in retirement and the need to implement the right retirement plan, a one-size-fits-all approach is rarely appropriate.
- Participants should be encouraged to consult a financial professional at retirement to determine if the target-date glidepath allocation is right for

[1] Vanguard How America Saves 2014. 51% of participants exited the plan in 2013 through a rollover (22%), cash lump sum (28), and rollover and cash (1%).

them, and if not, then abandon the glidepath in favor of a custom allocation.

Passive versus Active Strategies

In addressing this topic we must first define what is meant by passive versus active. All managers that establish their own glidepath (e.g., Fidelity Freedom Funds, Vanguard Target Retirement) are *technically* actively managed as the glidepath is proprietary and can be changed at any time, even if the manager has no intention to do so today. Only products that track a third-party benchmark, such as the Dow Jones Global Target Indices are truly passive.

However, the conventional industry definition is that products that are built exclusively from passive products are passively managed. Everything else is active.

Consistent with this broadly accepted definition, at the end of 2014, 67% of target-date assets were in actively managed funds versus 33% in passively managed funds.[2] As the table below illustrates, passively managed funds (the 2035 universe serves as a proxy for other vintage years[3]) have delivered comparable returns over the past seven years[4], while at the same time charge significantly less fees.

	2035 Active Universe	2035 Passive Universe
Median Return (7-Yrs)	6.2%	6.0%
Total Assets (Billions)	$471,465	$230,263
Median Fee	75 bps	24 bps
Number of Funds with 7-Year History	16	3

Active target-date strategies add value in two ways:

1. Glidepath management
2. Actively managed sub-funds.

[2] Source: Summit, Morningstar
[3] The 2035 vintage was chosen as it has a broad allocation to many sub asset classes.
[4] The number of active and passive funds with a track record longer than 7 years is quite low. This 7 year period includes 2008, a period in which active strategies could have added value.

Most target-date fund managers establish a glidepath for a 40 year period and only make changes to the design based on shifts within the capital markets. The most recent example was Vanguard's decision to increase the exposure to international equity and international fixed income by 10% (each). Contrary to the "set it and forget it" approach common in first generation products, some managers now actively manage their glidepaths by tactically allocating among stocks/bonds and at the sub-asset class level. Consistent with recommendations outlined in the US Department of Labor's February 2013 "Tips for ERISA Plan Fiduciaries" memo, plan sponsors should fully understand the product's strategy, including any changes since its initial selection some time ago.

The second level of active management is the use of actively managed sub-funds within the target-date products. While many managers utilize passive management for the most efficient asset class, large cap core, the remaining asset classes are typically actively managed.

Many Summit clients prefer passive off-the-shelf solutions for the following reasons:

- It should not be presumed that target-date fund managers are skilled tactical allocators of capital. Few managers have the skill to consistently add value through market timing calls, particularly if it is not their core strength like hedge funds, long/short and GTAA managers.
- Target-date funds should not have abrupt asset allocation shifts or performance surprises. When investing in a target-date fund, participants should have a clear long-term understanding of the strategy, particularly given the decision to use a target-date strategy is not periodically affirmed by the participant.

- The typical employee has five years of job tenure per the Bureau of Labor Statistics[5]. Given the cyclicality of active management, some target-date fund investors will benefit from active management and some will not, yet all will pay a significantly higher fee.
- Many target-date fund managers utilize more expensive active management in efficient asset classes that have a lower probability of consistently adding value.

Fund Structure

While there are a few instances of a target-date manager outsourcing asset management to external asset class specialists (e.g., Principal, John Hancock), the vast majority of products are based on a proprietary fund-of-funds structure. This has two challenges. The first is that the manager has a product in each of the asset classes critical to achieving diversification. This is the case for the largest and most comprehensive managers available (e.g., Fidelity, T. Rowe Price), but may not be for other managers who do not have the real asset or international equity/debt products.

The second (and greater) challenge is that their asset class products are competitive and *earn* their role within the glidepath. It is unlikely that every product within a manager's target-date suite ranks at the top of its peer universe. Often, a manager has a core strength, such as domestic equities, that is coupled with weaker products in global equities or debt. It is common for underperforming products to offset outperforming products, neutralizing alpha potential. Passive products like Vanguard and Wells Fargo have avoided the alpha game entirely by focusing on asset allocation only.

For sponsors who believe in active management and must offer a proprietary fund-of-funds structure, we recommend you focus on those managers that offer the broadest asset class exposure and are constructed from products that are competitive on a standalone basis. In the same vein that a chain is only as strong as its weakest link, the success of a target-date suite is dependent upon the strength of all its sub-funds.

Performance Measurement

Target-date fund performance[6] is typically measured using a proprietary benchmark that is created and reported by the manager. There is no industry standard methodology for constructing this benchmark. Unlike the common practice of using a third-party benchmark (e.g., S&P 500, Barclays Aggregate) to measure performance of a single investment product, target-date managers have complete discretion over how their multi-asset class benchmark is created and modified. This could include a dollar-weighted composite of each underlying product's benchmark, or a more generic policy benchmark.

Benchmarks should illustrate the value add from tactical asset allocation shifts, alpha from active management, or both. Failing that, then an attribution analysis should be provided that is easily understood by investors with degrees of investment savvy.

There has been a trend among target-date managers to simplify benchmark construction by using broad market indices, rather than the benchmarks specific to each of the underlying asset classes (funds). While this is easier for the manager, it provides less information for the sponsor and participant as the performance comparison does not identify the

[5] "Employee Tenure Summary," Bureau of Labor Statistics, September 18, 2014.

[6] Products not constructed to track a third-party index.

sources of over/under performance. Was the manager skillful in a way that can be repeated, or did it have more to do with benchmark composition? Plan sponsors are encouraged to scrutinize the manager's benchmark and determine if the benchmark construction includes any bias that could favor the manager, such as maintaining exposure to asset classes outside the composite or implementing a strategic overweight that adds value over time.

A Summit client recently asked, "What is more important, excess performance or peer ranks?" This is a great question that highlights a potential contradiction in evaluating all investments as underperforming funds can still be peer leaders and vice versa. Summit places greater weight on target-date peer ranks for the following reasons. First, proprietary benchmarks do not necessarily provide an optimal performance comparison for reasons described previously in this paper. Second, the majority of the portfolio's total return is driven by asset allocation, which is reflected in its total return peer ranking. Even a successful active manager with 100 bps of alpha cannot compensate for a poorly constructed glidepath and asset allocation.

Given the greater scrutiny of defined contribution plans subject to ERISA by regulators, it is imperative that sponsors use a suitable benchmark to evaluate their target-date offerings and understand what that comparison does, and does not, tell them.

Conclusion

Since their inception, many sponsors and consultants have evaluated target-date funds in the same manner they would other plan investments, by focusing on total return, peer ranks and risk metrics. While this is appropriate, there are additional design considerations that should be discussed before taking this step. These include:

1. Select an off-the-shelf or custom product with a set of design factors that closely align with the characteristics of participants. This increases the probability of participants achieving retirement readiness.
2. Make a decision to employ active or passive management based on a philosophical bias or sensitivity to potential underperformance and fees. Pay active management fees where there is a high degree of consistency in adding value.
3. Make a determination if the manager has exposure to, and is competitive in, the desired underlying asset classes. If the specific product does not offer this level of asset class exposure and management expertise, then a custom solution or one of the few off-the-shelf options that utilize third-party asset class experts may be a more suitable choice.
4. Determine what benchmark to use by focusing on the benchmark construction methodology and if it provides the type of information necessary to properly assess performance.

The considerations above will limit the universe of funds to consider and will ultimately lead to a product that is a better fit for the philosophical views of the sponsor and the investment needs of participants.

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