Target-Date Funds: Why Process Matters

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Key Takeaways

- Plan sponsors have a fiduciary obligation to follow a prudent process when selecting their target-date suite.
- Any evaluation of target-date funds needs to look beyond the "to vs. through" paradigm.
- It's important to work with an advisor who can help you create & execute an effective due diligence process.

Target-date fund usage exploded a decade ago when the Department of Labor (DOL) approved these investments as one of four qualified default investment alternatives (QDIAs). Their "set it and forget it" design appeals to most plan participants, making them one of the top investment choices for defined contribution plans. But with this explosion has come many questions. How do you select the "right" target-date suite for your plan? What constitutes a sound selection process? Does process really matter?

Four Reasons Process Matters

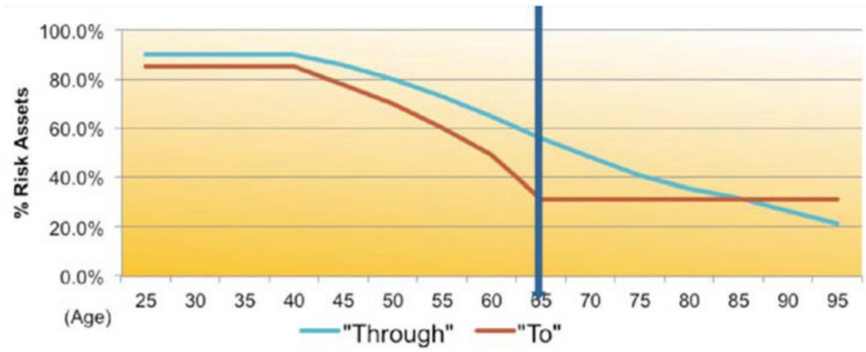
As with any investment option, you have a duty to conduct due diligence on any target-date fund you add to your plan's investment lineup. However, that's not the only reason process matters.

- **Department of Labor Concern (DOL).** The DOL's guidance on target-date funds shows it is paying attention to this asset class. Specifically, the DOL has mandated a documented, disclosed, rigorous process for selecting and monitoring target-date funds, especially when used as a QDIA.
- **Committee Expectations.** By identifying a fund's investment objectives and matching them to your investment preferences and demographics, your committee can find the target-date suite with the best fit for your plan. Under this approach, expectations will be better managed and more likely met, leading to lower turnover within the investment menu. Finding the right fit upfront also lowers the probability that a participant will be forced out of their target-date fund at exactly the wrong time (e.g., after a large drawdown).
- **Better Outcomes.** Comparing fund assumptions based on participant demographics can increase the odds of more appropriate and favorable investment outcomes. For example, suppose most of your participants take their assets at age 65. In that case, you don't want to choose a target-date fund that manages the assets based on an age 85 time horizon. You want one that mirrors your participants' average retirement age.
- **Better Solutions.** There are very few "bad" target-date funds out there, but they do exist. More often than not, satisfaction with a fund depends on a plan sponsor's expectations and knowledge of the fund at the start of the relationship. Using a multidimensional approach can help your committee select funds that are well designed and executed well.

Transcending the "To" vs. "Through" Paradigm

"How do I put this process in place" is the next question we typically receive after explaining why process matters. It starts by identifying the criteria you want to consider.

The investment industry generally categorizes target-date funds into two camps—“to” or “through” based on the glide path design.[1] Typically, target-date funds that stop the equity-to-fixed income roll down of their glide path at retirement are referred to as “to” funds. Those that continue managing the asset allocation process after the retirement date are referred to as “through” funds. The graph below illustrates this basic glide path difference.



This overly simplistic “to vs. through” categorization implies all “to and through” funds are managed the same way and that “to” funds are consistently less aggressive than “through” funds. These impressions, however, are misleading. The dispersion of risk profiles within a given category can vary significantly. There are many “to” funds that are managed more aggressively than “through” funds. Additionally, the risks that investment managers attempt to solve (e.g., longevity, sequencing, inflation, etc.) can result in materially different glide path designs.

To truly evaluate such a complex asset class, we need to look past the simplistic classification of “to vs. through” and evaluate funds based on plan sponsor needs, using a comprehensive framework of objective criteria.

Criteria for Evaluating Target-Date Funds

We use six main criteria for evaluating target-date funds that touch on each critical dimension of this asset class. These criteria are listed below by order of importance.

Glide Path

The risks and objectives the fund seeks to solve and the modeling assumptions used to construct the glide path

Asset Allocation

The breakdown between equity, fixed income and real assets at various stages of the participant experience

Portfolio Design

The structure of the product and the underlying funds

Management

The managers and resources directly responsible for the target-date fund and the individual management teams of underlying funds

Fees

The “all-in” expense ratio, the reasonableness of the cost relative to similar structures and the value received

Performance

How the fund stacks up relative to broad indices (S&P Target-Date indices) and peer groups

Three-Step Selection Process

Our goal is to provide the strongest possible outcomes for both you and your participants based on your goals, demographics and the above criteria. Through our three-step process, we’re able to rigorously screen the universe of target-date funds for you.

CERITY PARTNERS®

Step 1: Assess Your Preferences

The first step involves your plan committee completing a target-date questionnaire to share their preferences regarding glide path, asset allocation, product design and cost. This information gives our research team insights into the most appropriate style of funds for your plan.

Step 2: Gather Participant Demographics

From there, we use participant data about specific behaviors, such as savings rates and withdrawal patterns, to screen for target-date funds that use similar assumptions when modeling their glide paths.

Step 3: Analyze Investment Candidates

Once we identify potential target-date funds, we use our proprietary database to analyze each one based on the six criteria to arrive at a "best fit" recommendation that aligns with your preferences and participant needs.

Ongoing Monitoring

A prudent process involves not only the selection of your target-date suite but also ongoing monitoring. At Cerity Partners, we use a series of target-date-specific tools to help you complete this task:

- **Investment Policy Statement (IPS).** As a best practice, we incorporate language about the selection and ongoing monitoring of target-date funds into your IPS. This language is the foundation for regular reviews of your investment lineup.
- **Annual Target-Date Due-Diligence Report.** This proprietary report provides an in-depth analysis of the plan's target-date product based on the same six dimensions outlined earlier.
- **Investment Monitoring Report.** Every quarter, you receive an investment monitoring report that utilizes a proprietary scoring system called the Cerity Partners Investment SmartCard™. The SmartCard strategically scores and weighs various metrics (identified in the IPS) to comprise a final score that you can use to quickly evaluate the target-date funds. This quantitative score is supplemented by a qualitative recommendation regarding any issues about the funds.
- **Fiduciary Paper Trail.** Each report is archived to serve as a record for all committee discussions and decisions, which helps satisfy the DOL's documentation requirements.

Process Drives Outcomes

The growing usage of target-date funds and increasing regulatory scrutiny reinforce the need to have a well-defined process that satisfies your fiduciary obligation and drives better outcomes for your participants. Many marketplace comparison tools use an overly simplistic methodology that fails to meet the procedural requirements of a sound process.

In contrast, we use a process built around the DOL's guidance to better segment and analyze these funds. Through our comprehensive approach, we can help you select the target-date suite that best meets your needs while governing and documenting the process along the way. Contact a Cerity Partners retirement plan consultant to learn more or visit ceritypartners.com.

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[1]A glide path is the change in the asset allocation mix (i.e., stocks, bonds, real assets, etc.) over an investor's time horizon and is based on the number of years to the target-date.

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