

As the popularity of target-date funds continues to grow, defined contribution plan sponsors should make sure their plan participants understand how to best use these investments.



by | **Deb Rosenberg, CEBS**

# Target-Date Funds:

## Help Plan Participants Hit the Mark

**T**arget-date funds (TDFs) account for more than \$1 trillion in retirement plan investments.<sup>1</sup> Inflows to these funds every payroll period far surpass those of other investments in qualified retirement plans. As the popularity of TDFs continues to grow, defined contribution (DC) retirement plan fiduciaries should pay attention to how their participants are using these investments.

While plan sponsors have a fiduciary duty to monitor TDF composition and performance, they should also be aware that incorrect usage by participants could result in a failure to invest appropriately for a comfortable retirement. Plan sponsor awareness and action can help encourage better outcomes.



### TDF Popularity

TDFs are mutual funds that invest in a mix of assets that is automatically reset at specific times as the target date approaches. TDF investments gravitate to less volatile options as the participant grows older, without requiring participant action. Investors typically choose a fund with a target date that is near their planned retirement year.<sup>2</sup>

TDFs are now the most commonly used qualified default investment alternative (QDIA) across all plan sizes (79%) and are used most often in plans with more than 1,000 participants. Other QDIAs include balanced funds (10%) and managed accounts (6%).<sup>3</sup> According to the BlackRock 2018 *DC Pulse Survey*, plan sponsors are closely reviewing their QDIA selection, with 18% of plan sponsors selecting a new QDIA in the last two years.<sup>4</sup> In addition, 19% considered changing TDF providers, and 28% considered adding white label, customized or multiman-ager solutions.

The list of TDF providers, available funds and available share classes continues to grow, which brings complex-

ity to the market and to the investment selection and oversight processes. Of the more than \$1 trillion invested, the largest percentage of money is held by five firms: Vanguard (34%), Fidelity (20%), T. Rowe Price (15%), American Funds (8%) and J.P. Morgan (5%).<sup>5</sup> According to a T. Rowe Price survey, 94% of large market plans offered TDFs in 2017. And more than 40% of total plan assets were invested in TDFs, making it the dominant asset class.<sup>6</sup>

### Participant Use of TDFs

Beginning in the 1980s, 401(k) plans increasingly allowed participant direction of investments, but it has been apparent that many participants are intimidated by making these decisions. Most employees don't understand investments and don't want to learn. Employees across the age, service and pay spectrum have embraced the "do it for me" options offered in DC plans. TDFs seem like a logical solution—recognizing differences in risk tolerance and time horizon—but they're not as simple for participants to understand and use as they might seem on the surface.

TDFs are structured to be a one-stop shop for participants based on their age and years until retirement, so participants who select them or default into them typically should not be investing in any other fund. The T. Rowe Price survey showed that 22% of participants have only a partial balance in a TDF, although there appears to be some improvement in this trend. According to a Vanguard report, more than half of 401(k) participants are invested in a single TDF vs. 13% just ten years ago.<sup>7</sup> This positive trend appears to be driven by plans with autoenrollment and default investments—Participant inertia keeps more individuals in the single TDF that they were defaulted into.

Research by Alight has noted that only 9% of participants understood that a TDF is designed to be a single investment.<sup>8</sup> Flipping that around, 91% don't understand this! Another study noted that 62% of participants didn't invest in a single TDF because "they were seeking to diversify their investments."<sup>9</sup> Responses included "you never know what could happen, and I don't want all my money in there" and "I do not like having all my eggs in one basket." The authors of the study note that partial TDF users had a 2.11% lower return than participants who used a single TDF. So what can employers and plan sponsors do about this?

TDF guidance from the Department of Labor (DOL) requires plan sponsors to "develop effective employee communications." It appears that these communications often aren't working.

### DOL Guidance— Some Reminders

The February 2013 DOL report *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries* provides a road

## takeaways

- Target-date funds (TDFs) account for more than \$1 trillion in retirement plan investments and are the most commonly used qualified default investment alternative (QDIA).
- TDFs are mutual funds that invest in a mix of asset classes that is reallocated on an ongoing basis to become more conservative as the target date approaches.
- Many participants fail to understand that TDFs are structured to be a single investment, based on their age and years until retirement, and invest in more than one TDF.
- Retirement plan sponsors have a responsibility to select a TDF family that is a good fit for their plans and employee base. The Department of Labor (DOL) specifically notes that plan sponsors should establish a process for comparing and selecting TDFs and for periodic review.
- Ongoing monitoring should include a review of TDF use by participants. Recordkeeper data can help plan sponsors identify how many participants are selecting TDFs, which TDFs they are investing in and how much is invested in each of the available funds.

map for plan oversight committees and investment advisors to follow in the selection and ongoing oversight of TDF offerings.<sup>10</sup> The DOL noted that because “TDFs may have different investment strategies, glide paths and investment-related fees . . . it is important that fiduciaries understand these differences when selecting a TDF as an investment option for their plan.” This is particularly true five years later as the number and type of TDFs continue to increase. The fund family that plan sponsors select needs to be a good fit for their plans and the employee base. It also needs to continue to be a good fit.

### Selection and Monitoring

The DOL specifically notes that plan sponsors should establish processes for comparing and selecting TDFs and for periodic review. A plan with TDFs should ensure that its oversight committee has the expertise to perform this analysis or that the committee enlists appropriate outside help. The plan should maintain thorough documentation of all decisions.

As the TDF universe has grown and evolved, the DOL mandate to “understand the fund’s investments—the allocation in different asset classes (stocks, bonds, cash), individual investments and how these will change over time” has become more complex. Decision makers need to understand asset class allocations and how they change over time (the glide path), passive vs. active investing, use of proprietary funds and more. A plan recordkeeper that originally had only a single TDF option on its platform may have added options, so it is critical to understand all of the options in order to assess whether the plan is offering the most appropriate TDF for plan participants. This includes assessing different fund families and different share classes.

Ongoing monitoring also should include a review of TDF use by participants. Recordkeeper data can help plan sponsors identify how many participants are selecting TDFs, which TDFs they are investing in and how much is invested in each of the available funds. In addition, plan sponsors should look at the characteristics of the participants in each TDF, such as their age and years of service with the company. Plan sponsors can determine who has been defaulted into a fund based on age and who has actively made an election into a fund—for example, an older employee who has invested all of his or her money in a 2045 fund or a younger employee who has selected the 2020 fund. These participants

have selected a fund that is more aggressive or more conservative than recommended, so the selection may be based on their individual objectives rather than a set retirement date.

Plan sponsors also can look at how many participants have money in multiple TDFs or have money both in a TDF (or TDFs) and individual funds offered in the plan. As noted above, a large number of individuals make elections that go against the TDF design. Fund managers have developed a one-stop alternative that is well-diversified and professionally managed to meet the investment objectives of a plan participant of a specific age and number of years until retirement. Granted, this is being done based on an “average participant,” and a group of 40-year-olds may all have different investment objectives, but the goal is to provide a good investment option for employees who aren’t comfortable making their own choices.

In monitoring their TDFs, plan sponsors should pay attention to asset allocation and glide paths, which can vary substantially among different fund families. What’s the right mix for an individual plan? There is no one right answer. When evaluating a TDF offering, plan sponsors should be sure they understand the plan participant population, including age range and average age, income levels, education and sophistication, current investment patterns and average length of service. The makeup of the population may have changed after the plan originally introduced TDFs and should be reviewed periodically.

### Communication

#### *Proper Use of TDFs*

Plan sponsors that discover that participants are using these funds as only a portion of their investment mix or are using funds that seem to conflict with their age may decide to offer some broad investment education to all employees emphasizing the benefits of using a single TDF. Or they may create messages targeting those individuals.

Some participants may have decided to use a TDF and some funds in individual asset classes based on conversations with their broker/advisor. Or they have very consciously decided to use a more conservative or more aggressive TDF based on their broader financial picture. They may have decided that their other assets, for example, are all very conservative so they want to be pretty aggressive with their balance in the plan.

However, other plan participants may have misunderstood industry messaging about diversification. They understand that diversification is a good thing, but they don't understand that TDFs are already well-diversified and that having money in three or five different TDFs creates investment overlap, defeats the intended purpose and alters the intended risk profile and glide path. A few minutes spent looking at fund fact sheets can help them understand that a single TDF has a diverse mix of stocks and bonds and a wide variety of individual securities and asset classes.

Participants who appear to be investing in TDFs that are out of alignment with their age may simply be confused about basic investing principles around risk, volatility and how the markets have historically performed over different time periods. Young participants may be scared off by the possibility of a stock market downturn like the one experienced in 2008 and early 2009 and invest very conservatively—often too conservatively for the almost 40 years of work that lies ahead of them. They have time on their side to live through the ups and downs of the market if they can understand and accept the level of risk involved.

On the flip side, older employees may be trying to make up for not having saved enough by taking much more risk. Plan sponsors should communicate with employees in this category to make sure they understand their time horizon and the potential volatility their investment mix may deliver. A down market may have a dramatic impact on their ability to retire when and how they would like to.

The challenge with this type of participant communication is determining the method to use. Participants may ignore broad-based education, and personalized communication can be expensive. Making someone available to have one-on-one conversations with participants might seem ideal, but many plans don't have the resources through their advisor or recordkeeper to handle the volume.

Plan sponsors should evaluate the support that is currently available, or could be made available, from their recordkeeper and/or investment advisor. For example, using reports from a client's recordkeeper, the author's firm sent personalized emails to individuals using multiple TDFs or a TDF and other individual mutual funds. The firm made staff available to talk with these participants if they wanted to discuss their allocation decisions.

### *Understanding Fees*

The DOL emphasizes the importance of understanding TDF fees along with all plan expenses. From a participant communication perspective, plan sponsors may want to revisit how they describe the TDF array that is available in the plan.

Plan sponsors that have consciously chosen actively managed TDFs over passively managed funds may want to help participants understand the reason behind that decision, since it means that the expense ratios are higher than for passive investment options.

According to Morningstar, nearly 95% of the \$70 billion in estimated inflows to TDFs in 2017 went to TDFs that invest at least 80% of assets in index funds, which are passively managed.<sup>11</sup> This has made a large impact on fees because index funds are less expensive. The average asset-weighted expense ratio for TDFs overall fell to .66% at the end of 2017, compared with .91% five years earlier. Actively managed TDF expense ratios ranged from .46% to .60%, while passive TDF expense ratios ranged from .10% to .13%.

Whether the plan sponsor selects actively or passively managed TDFs, following a prudent process and documenting that process is essential. Plan sponsors can proactively shape participant perceptions of fees, which is critical in this era of increased litigation against DC plan sponsors.

### *Use of TDFs in Retirement*

Plan sponsor monitoring efforts may overlook how employees behave at retirement—Do they take their money out of the plan as soon as possible, or are they leaving their balance in the plan? If an employer's population of participants age 65 and over is increasing, as many are, the employer should pay close attention to the TDF risk characteristics for participants who are "in retirement." This is another area where communication comes into play. Plan sponsors can encourage retired employees to consider leaving their money in the plan in order

## learn more

### Education

**38th Annual ISCEBS Employee Benefits Symposium**  
September 8-11, New Orleans, Louisiana

Visit [www.ifebp.org/symposium](http://www.ifebp.org/symposium) for more details.

**Certificate Series—401(k) Plans**  
June 26-27, San Diego, California

Visit [www.ifebp.org/certificate-series](http://www.ifebp.org/certificate-series) for more information.

to take advantage of this professionally managed, well-diversified and typically cost-effective way to invest.

Keeping track of all of those individuals might be a concern, but the plan recordkeeper might be capable of taking the lead, and it might not be burdensome for the plan sponsor's staff. Older employees may view it as a nice benefit.

## Lawsuits

DC plan sponsors continue to be subjected to lawsuits that include claims of improper use of TDFs. These lawsuits have focused primarily on the use of proprietary funds vs. other available funds and the use of active vs. passive strategies. These choices impact participant fees, and many of the lawsuit claims are fee-related.

In addition, some claims have alleged that the TDFs in an individual plan are underperforming. This type of claim is very subjective and raises the question of what the appropriate benchmark is for both fees and performance. The level of risk being taken by a fund will have a direct impact on its performance, and it is difficult to compare apples to apples. TDF families with a more conservative orientation have underperformed aggressive fund families in the recent bull market but may outperform in a downturn. This distinction emphasizes the need for plan sponsors to document the reasons for selecting the TDF family and possibly conduct some ongoing participant education emphasizing the objectives in selecting the plan's TDF series.

## The Future

It's difficult to predict future developments in the TDF landscape, but possibilities include TDF providers paying more attention to designing "in retirement" funds that assist in the drawdown process, i.e., to be used as a decumulation vehicle. And, since many 401(k) participants no longer have pensions, more plan sponsors may become interested in TDFs that contain an annuity feature.

Retirees typically must be more risk-averse and concerned about the impact of a market correction early in their retirement, i.e., aware of the sequence-of-returns risk, so this may become a component of a committee's TDF monitoring and

bio



**Deb Rosenberg, CEBS**, is director of retirement plan consulting at Stiles Financial Services, Inc., in the greater Minneapolis-St. Paul, Minnesota area. She is a retirement plan specialist with more than 30 years of experience in bank trust company and consulting environments. Rosenberg is active in the Twin Cities Chapter of the International Society of Certified Employee Benefit Specialists (ISCEBS), the Midwest Pension Conference and the Minneapolis Pension Council. She is an ISCEBS Fellow, an Accredited Investment Fiduciary® (AIF) and a Certified Plan Fiduciary Advisor® (CPFA). Rosenberg holds a B.A. degree from Gustavus Adolphus College and has her FINRA Series 6, 63 and 65 licenses.

assessment, especially if more participants leave their money in plans at older ages and in retirement. And, if more retirees do leave money in 401(k) plans, their ongoing use of TDFs is also tied into a plan design feature—Plans will want to review their distribution options to ensure that periodic and flexible options exist rather than just lump-sum payouts. 📌

## Endnotes

1. "TDFs Top Trillion Dollar Mark," NAPA Net, May 15, 2018.
2. *Employee Benefits Glossary, 13th Edition*. International Foundation of Employee Benefit Plans. 2016.
3. Plan Sponsor Council of America. *59th Annual Survey of Profit Sharing and 401(k) Plans*.
4. BlackRock 2018 *DC Pulse Survey*.
5. Morningstar. *2018 Target-Date Fund Landscape*.
6. T. Rowe Price. *10th Annual Reference Point Benchmarking Report*.
7. Vanguard. *How America Saves 2018*.
8. Alight. *Target Date Funds: Who is Using Them and How are They Being Used?* 2017.
9. Financial Engines. *Not so simple: Why target-date funds are widely misused by retirement investors*. 2016.
10. Department of Labor. *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries*. See [www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf](http://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf).
11. Morningstar. *2018 Target-Date Fund Landscape*.



pdf/319