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Evaluating Whether Your Target-Date Fund Measures Up

As the Labor Department signals its interest in weighing in on these funds, plan sponsors should make sure their evaluation process is in place, and that it's thorough and well-documented.

By Lori Lucas

Do plan sponsors view target-date funds as interchangeable? Results from Callan's recent Defined Contribution Trends Survey indicate that some may. In the survey, approximately two-thirds of defined-contribution plan sponsors reported that they offer their record keeper's proprietary target-date mutual fund or collective trust. This is true even though the same plan sponsors gave a very low ranking to the importance of their target-date fund being the proprietary fund of the plan's record keeper. What ranked at the top of the list? Portfolio construction.

So why the heavy use of record keepers' target-date funds? It strains credulity to believe that the proprietary target-date funds happen to be the best fit for so many plans, given all the target-date funds available. A more likely reason is that plan sponsors may be struggling to identify the differences between target-date funds, and how these differences translate into appropriate target-date fund selection for their plan.

The importance of these issues should not be understated. In 2008, there was more than a 20 percentage point spread between target-date funds that performed in the top and bottom fifth percentiles of the 2010 peer group. In 2009, that spread was almost as wide, at 18 percentage points.

This broad dispersion comes from significant variations in the asset allocation, or glide path, of target-date funds. For example, examining the universe of target-date glide paths available, we find one target-date fund that starts out with nearly 100 percent in equities (for the 2050 fund geared for investors who are age 25 today), and declines to 60 percent in equities by the time the investor reaches age 65. But another target-date fund in that universe has equities starting at 90 percent, and declining to under 20 percent at retirement age. Differences in structure within equities (domestic versus international funds, for example) and fixed-income investments (high-quality bonds versus high-yield bonds) also abound, as do variations in rebalancing approaches.

So how does a plan sponsor get a deeper look into their target-date fund's structure and—more importantly—evaluate the structure on behalf of participants?

One of the key variables that plan sponsors should consider is whether the target-date fund's glide path is managed "to" or "through" retirement. The asset allocation of target-date funds that are managed "to" become fixed at retirement age, with no further shift out of equities occurring in retirement. If the participant remains in such a target-date fund during retirement, he or she will have the same asset allocation at ages 65, 75, 85, etc. The typical rationale for a "to" target-date fund approach is that once retirement begins, it is appropriate that the asset allocation should make a one-time shift to whatever may best accommodate the withdrawal phase for participants.

In contrast, the asset allocation of target-date funds that are managed "through" retirement continues to change, becoming more and more conservative and oriented to fixed-income investments until ages 75, 80 or even later. The typical rationale for the "through" approach to target-date fund management is that protection against the risk that the participant will outlive his or her retirement money needs to continue to evolve for investors throughout much of

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retirement. Greater protection (generally in the form of greater equity exposure) is required early in retirement, and less protection is required later in retirement.

Accordingly, it may be argued that whether a "to" or "through" target-date approach is appropriate for the plan will depend on which philosophy best fits participants' actual withdrawal patterns and their need for protection against the risk of outliving their money.

Making all of this even more complicated is the fact that not all "to" target-date funds are managed to be conservative at retirement, nor are all "through" target-date funds managed to be aggressive at retirement. As in the case mentioned above, the supposed "to" glide path of one target-date fund has such a shallow shift into conservative investments that it ends with 60 percent in equities at retirement—and remains at that level. Meanwhile, there is an instance of a "through" glide path that arrives at just under 20 percent in equities by age 75 and then stays there.

It can be argued that the right approach for a plan can depend on participant demographics and other factors. If plan sponsors believe that participants are unlikely to hold fast to their retirement investment program over the long term (for example, that they are likely to take withdrawals or lump-sum distributions, or transfer out of the target-date fund during turbulent times), a steep shift out of equities, resulting in modest exposure to them at retirement, may be deemed most appropriate.

Conversely, a recent study by Callan found that for long-term target-date fund investors, equity-investment reductions that are too steep—with a great deal in fixed income throughout—can result in significant reductions in retirement income for participants under many market scenarios. If plan sponsors view their target-date funds as long-term holdings for participants, the shallower shift, resulting in higher equity exposures at—or even through—retirement, may be deemed most appropriate.

One of the best ways for plan sponsors to understand the trade-offs of target-date fund structures is to use forward-looking simulations to project possible outcomes. These trade-offs include:

- Likely versus worst-case income-replacement projections
- Longevity risk (the risk of outliving one's assets) versus excess market volatility
- The probability of meeting a certain income-replacement goal versus the risk of short-term loss (a one-year loss, for example) near or at retirement

Plan sponsors—who generally know their plan needs better than anyone outside their organization—can prioritize and weight these trade-offs to determine the best target-date fund fit. Because plan needs vary, plan sponsors' views of these trade-offs will likely range as well, resulting in an "ideal" target-date solution that may look quite different for one plan versus another when this type of analysis is applied.

Plan sponsors without access to simulation technology have other evaluation tools at their disposal. A number of target-date fund indexes are now available, as are target-date peer groups. Plan sponsors can use these indexes and peer groups not only to evaluate relative performance, but also to parse what is driving returns and risk. Does the target-date fund's glide path differ dramatically from the average? If so, are the differences acceptable and in keeping with the goals of the plan? Has the glide path changed? If so, are the changes well-explained, consistent with the overall investment management philosophy, and palatable?

According to Callan's DC trends survey, the most common metric used by plan sponsors in measuring target-date fund performance is the passive benchmark provided by the target-date fund investment manager. This can clearly help plan sponsors understand the extent to which target-date fund managers are adding value through active management, but it will not aid them in monitoring the efficacy of the glide path itself. If the passive benchmark provided by the target-date fund manager is the only metric used—and the asset allocation of the target-date fund is not being evaluated on an ongoing basis—then plan sponsors are holding their target-date fund managers accountable for just a portion of their overall performance.

The stakes are likely to get higher on the topic of target-date fund selection, evaluation and monitoring. The Employee Benefits Security Administration has indicated that it plans to weigh in on this subject. Preliminary signals suggest that the administration's guidance will focus on the process used, rather than on anointing any given target-date fund approach as good or bad. Plan sponsors who wish to be ahead of the curve will not only make sure a target-date fund evaluation process is in place, but that it is also thorough and well-documented.

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