

12 Questions to ask about Target Date Funds

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October 11, 2009 --- Asset-allocation fund solutions have, to put it mildly, exploded on the retirement plan scene—aided in no small measure by the sanction of the Department of Labor’s final regulations regarding qualified default investment alternatives (QDIA).



However, the recent market turmoil has drawn a fresh, heightened scrutiny to the philosophy and structure of these popular defined contribution choices and, certainly for plan sponsors, reminded us all that there are differences—significant differences, in fact—in how these vehicles are constructed, how they are managed, and even the philosophies underpinning those designs.

Now, the “right” answer for any particular program will, in many respects, be unique to that program. On the other hand, there are certain basic questions that plan sponsors – and their retirement plan advisers - should know the answers to in choosing an asset-allocation solution.

Getting Started

1. Are we talking about lifestyle or lifecycle funds?

The terms are used interchangeably all too often. However, funds that structure their allocation based on an individual's risk tolerance (risk-based) are generally called lifestyle funds. Those that base that allocation on a specific future date (date-based) are referred to as lifecycle funds or, more broadly, target-date funds. While the latter was more prominently cited in the DoL QDIA regulations, a properly structured risk-based fund could work as well—and has seemed to enjoy a much greater receptivity in the marketplace even before those regulations (see #2 below for at least part of the reason). Some plans have both on their plan menu, but that can complicate plan communications. On the other hand, IMHO, risk is going to loom larger on people's minds going forward.

2. Is a risk tolerance questionnaire part of the process?

In my experience, no matter how short and “approachable” the process of ascertaining a participant's tolerance for risk, it is never going to be something that is comfortable for most. Still, if you are employing a risk-based solution, you have to have something to base that tolerance on—and you should make sure how comfortable you are with that process/document. Additionally, today there are several risk-based target-date offerings that combine both approaches. I've tended to be skeptical about these—IMHO, many still focus more on the risks of losing money than the risks of not having enough money to live on—but, short of imposing some kind of generic sense of tolerance, you have to have some means of assessing comfort with risk if you are going to employ a risk-based alternative.

3. What kinds of history/benchmarks are available?

Just a couple of years ago, there were no benchmarks to speak of in this space (other than those constructed by the firms managing those funds, and those were often composites). Of course, just a couple of years ago, there were not enough funds in this space with enough history to make for a meaningful evaluation. However, time has provided the history many funds were lacking (granted, many would just as soon not have that fourth quarter 2008 result included)—and a new generation of benchmarks and indexes has emerged along with the explosion in these funds. But take note: The benchmarks today are as varied in their underlying philosophy and construction as are the funds themselves. IMHO, you need to first know what you believe about the approach, glide paths, and/or asset allocation before you pick the benchmark.

Fund Construction

4. Are the funds composed of proprietary offerings, or are they “open architecture”?

The “debate” over the relative advantages of open architecture versus proprietary offerings has long been part of retirement plan administration choices, and it is part of the target-date decision as well. Those advocating the benefits of open architecture generally tout the ability to pick “best of breed” investment solutions (while readily being able to dump those that fall short), backed by the notion that no one firm can possibly be that best choice across every asset class. Those pushing proprietary choices take issue with that latter point, while pointing to the benefits of their intimate knowledge of their own product set—not to mention the relative cost efficiencies of a proprietary product. There is no right answer, IMHO, but the determination should be part of your evaluation.

5. What IS an appropriate asset allocation?

This is the million-dollar question for target-date funds these days. At a high level, this is no more complicated than deciding what is the right mix of stocks and bonds, international and domestic, alternative investments and/or cash for investors at every stage of their investing life—or than picking the firm(s) that you trust to know what that right mix is.

6. How much of what is on your glide path?

The “glide path” sounds like a complicated concept, but it is actually nothing more than how the shifts in asset allocation take place over time. It is the path that these investments take your money on throughout your investing life. Still, for some funds—particularly newer, smaller funds—the asset-allocation strategies outlined in the fund prospectus or fact sheet may still be “aspirational,” may not yet incorporate all the specific strategies that the fund manager has in mind for that time in the future when the funds achieve a certain critical mass. You need to know what the targets are—and know if those targets are part of the current strategy.

Fees

7. Do the funds have a fee “wrapper” in addition to the underlying fund charges?

Particularly when a provider incorporates other funds in their offerings, they frequently charge some kind of fee for their expertise in putting together those other funds. This is a fee generally applied as some kind of basis-point charge in addition to the other, regular fees charged by the underlying funds. You will want to know what this charge is, if any, and consider it as part of the total cost of your selection. This fee is generally smaller (sometimes there is no extra charge) for proprietary-only offerings.

8. What are the fees charged by the funds?

Beyond the aforementioned “wrapper” fee, these funds will have all the same kinds of fees typically associated with retirement plan investments. Bear in mind that some of the fund allocations may include some relatively exotic asset classes—and those may carry higher expenses than you are accustomed to seeing. Additionally, you may find some retail share class funds included, even in institutional share class offerings. The bottom line: Keep an eye on the bottom line.

Plan Design

9. Does it fit your investment policy statement?

Most (though not all) retirement plans have an investment policy statement—that essential blueprint for monitoring and managing the investments you make available on your plan menu, set alongside the objectives you have established for your program. However, the blueprint set out for plan investments before asset-allocation solution is introduced may not take their unique contributions—or considerations—into account.

10. How many “life” options are available on the recordkeeper’s platform?

For many plan sponsors and advisers today, there is a harsh reality at the end of the due diligence “rainbow”—a limited number of asset-allocation options available on your recordkeeper’s platform. In fact, it was not that many years ago that most plan sponsors could only pick from a single option. Limited choices may seem to make the decision easier, but these offerings are not identical, and you and your plan will be better served if you are able to evaluate and choose from a variety of options.

11. They can be misused.

No matter how hard we try to make these types of solutions “idiot proof”—well, let’s just say that you should take nothing for granted. Odds are that automatically enrolled participants defaulted into a QDIA will not fall prey to such mistakes. But, after years of being counseled that they should not “put all their eggs in one basket,” well-meaning participants have been known to try and split their investments across more than one asset-allocation solution. Fortunately, many recordkeepers today can apply system edits to prevent (or at least warn about) such missteps—and advisers also can certainly play a role in this education.

12. Should everyone who retires in 2020 (or 2010, or 2030, etc.) have the same asset allocation?

The simple answer to that question is, probably not. On the other hand, as an alternative that can broadly and efficiently address perhaps the most daunting participant savings obstacle, it is hard to think of a better solution. That is not to say, however, that this solution cannot, with the engagement and involvement of plan fiduciaries – and the advisers who counsel them - be made even better.

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