

# A Fiduciary's Guide to Target Retirement Date Funds

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In the throes and aftermath of one of the deepest recessions we have ever faced in the U.S., a popular retirement plan investment option that was designed to help participants to properly diversify throughout their investment lives has come under intense scrutiny.

Target retirement date funds (sometimes referred to as target retirement funds or target date funds) have recently become a popular way to help less knowledgeable investors map out an investment path to retirement. Through a single mutual fund offering, a target retirement date fund provides exposure to different asset classes in various age-appropriate "mixes", depending on the expected retirement date of the investor. Many plan sponsors liked the concept and offered the funds. Many participants subsequently invested in these funds, expecting that as they approached retirement, they would be invested conservatively.

While this is fundamentally how the funds work, most plan sponsors and participants did not realize the vast differences in how these funds are constructed and packaged by the different fund companies that offer them. For starters, there are significant differences in equity exposure and the rate at which this exposure changes over time. Compounding the problem, few plan sponsors asked the right questions when deciding which funds to offer and how to educate participants on the plan's offerings. As a result, the average target retirement date fund investor who was expecting to retire in 2010 (by choosing a "2010 fund") was shocked to find that his investment in that fund had lost 23% of its value in 2008, a fact documented by Ibbotson Associates. And this was just the average – at least one 2010 fund lost over 40% in 2008, clearly not the sort of loss anyone would expect to sustain that close to retirement.

We are just beginning to feel the impact of this situation. On June 18, 2009, the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) held a joint public hearing on these funds, hoping to determine the need for future guidance in this area. A few months prior, Morningstar, Inc., one of the largest mutual fund ratings organizations in the industry, announced that they would soon offer ratings and in-depth research reports for target retirement date funds, to make them easier to benchmark and compare to each other.

Despite all the controversy, target retirement date funds can be an effective investment tool when used properly. The problem is they are often offered without much thought. Plan fiduciaries need to be aware of the various issues involved. This will determine whether they offer such funds, how they should select target retirement funds, and how they ought to educate their participants. This paper is designed to provide a basic overview of these funds, some of their pros and cons, and various considerations in this area. It does not constitute a legal opinion, nor is it a substitute for professional investment advice.



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## What is a target retirement date fund?

The concept of a target retirement date fund is fairly simple. It is a single mutual fund, which is usually made up of other, individual funds offered by the fund company (making it a “fund of funds”), that is designed for an investor who expects to retire in a given year, for example a “2030 fund”. The asset allocation mix of the fund varies over time, becoming more conservative each year by reducing the fund’s equity exposure, so the participant’s investment is theoretically kept in an age-appropriate asset allocation throughout his life. This pattern of how the allocation varies over time is typically called the fund’s “glide path”. Typically the fund reaches a final, stable level of equity exposure when the target retirement date is attained or sometime thereafter.

## Why were these funds developed?

There are several reasons why these funds were developed. Among them are the following:

- The typical participant does not know enough about investing to make appropriate asset allocation and investment decisions – he is looking for a “simple” approach to making his asset allocation decision, or to have someone else make it for him.
- The typical participant chooses his asset allocation initially when he becomes eligible, but often does not change his asset allocation for many years thereafter, if at all.
- It is a widely held belief that participants/investors need to maintain some equity exposure over time to attain investment returns that exceed inflation by a meaningful amount, and to give them the best chance of accumulating significant retirement assets.
- Younger participants generally have more capacity for risk than older investors, both because they have time to ride out ups and downs in the stock markets and because they often have more years of stable employment income ahead of them.

A target retirement fund gets a participant into a diversified portfolio that changes over time, becoming more conservative as he approaches retirement.

## What are the benefits of target retirement date funds?

Despite all of the recent negative press, there are some significant benefits to these funds. Here are some of the advantages to this approach:

- In theory, they are very easy to understand by plan participants and other investors.
- They are a big improvement over the typical participant’s tendency to let emotions dictate his asset allocation decision and to invest to the extreme (too low or too high an equity exposure) – fund managers are generally better at investment, asset allocation, and rebalancing decisions than the average investor.
- They facilitate efforts by plans to offer automatic enrollment, particularly due to their recent blessing as a “Qualified Default Investment Alternative” (QDIA) by the Pension Protection Act of 2006.
- They are a useful way to work around the inertia of the typical investor, who often does not reduce his equity exposure as he approaches retirement.
- Studies have shown that in the recent market downturn, investors in target retirement date funds and similar investments were less likely to jump ship and race to fixed income or other more conservative investments than the typical investor.

## What are some of the concerns with these funds?

Most of the concerns seem to surround the general lack of consensus and consistency among various providers of how these funds should be structured, and how the plan sponsors choose to apply the funds to their situations. There are some fundamental design issues inherent in these funds, depending on who is offering them and the characteristics of the plan looking to utilize them. There is also a concern about the participants' lack of knowledge regarding the actual equity exposure in a given target retirement fund at any given time.

- 1) **Difference in Philosophy Among Providers** - Perhaps most significantly, the funds vary enormously from provider to provider in philosophy, underlying assumptions, glide path, and what constitutes an appropriate portfolio for a given age. For example, the percentage of equities in 2010 target retirement funds varies from less than 15% to over 60% - clearly a vast difference in philosophy. For this reason, the funds are very difficult to benchmark, which is one of the core duties of a plan fiduciary in comparing fund offerings from various providers. One of the main reasons for this wide variance is that there is no consensus among providers on what an appropriate glide path should really be. Glide paths vary by investment philosophy, and often do not take into account payments out of the fund (e.g. age 70 ½ minimum required distributions). They are structured for accumulation, not de-accumulation. The plan sponsor does not usually have a lot of information on these differences in approach or basic design principles, and often just chooses which funds to offer based on past performance. Even worse, a sponsor may decide to offer target retirement funds for the wrong reasons – thinking they can eliminate or at least reduce their employee education efforts.

Some other difficulties arise from the fact that the funds are typically designed for someone with average risk tolerance, a concept which can vary by provider. While this in and of itself is not a problem, once again there is a lack of consensus that potentially results in confusion. Even the chosen retirement date itself may have inconsistent meaning among fund companies. For example, some funds may achieve the stable, "income" glide path at the given target year, and some by design may not attain this for a decade afterwards.

- 2) **Difficulty in Properly Educating Participants** - Unfortunately, since these funds are usually seen as an easy-to-use option, the plan sponsor often neglects to educate participants on what all of this means for the plan's participants. As a result, risk-averse and aggressive investors may not be invested appropriately if they simply choose the fund closest to their retirement date. Another shortfall in education is the plan sponsor does not usually educate participants to take into account other assets and other sources of income (e.g. a pension benefit or Social Security). So what started as a "simple" investment choice has the potential to become a dangerous one for both sponsor and participant if the proper education is not provided, which is unfortunately far from simple.
- 3) **Fiduciary Duty to Monitor Underlying Actively-Managed Funds** - Even if the plan sponsor understands all of this, there are other pitfalls. For example, some fund companies offer target retirement date funds that include some underlying funds that are less-than-stellar performers, particularly where actively managed funds are concerned – and sponsors do not have a choice in the underlying funds, unless they switch companies. This may not simply be because this is the only fund offered by that company in a particular asset class – some poorer-performers are deliberately included to garner more assets. In addition, actively-managed funds tend to be higher-expense funds that significantly eat into returns over time.
- 4) **Other Issues to Consider** - There are also plan-specific questions to be answered in the process of offering these funds, which unfortunately all too many sponsors neglect. For example, what are the savings patterns of employees? How knowledgeable are the employees regarding investments? How likely are they to have other investments? Do they have a defined benefit pension plan? When they quit, do they often leave their money in the plan until retirement? Do the funds' underlying assumptions and philosophy line up with the patterns for this particular plan?

## What should a plan fiduciary do if the plan offers or is considering offering target retirement date funds?

- 1) First and foremost, a fiduciary ought to be well aware of the strengths and weaknesses of this approach as outlined here and elsewhere. These should be kept in mind as the fiduciaries look at the different offerings of different fund families. It should be recognized that while flawed, target retirement date funds can be very useful if their limits are known and appropriate action is taken in administering a target retirement fund program.
- 2) A fiduciary should strongly consider a mostly index/passive approach when offering target retirement date funds. Compared to target retirement funds that contain actively-managed funds, this approach offers the following advantages:
  - Minimizes plan expenses.
  - Provides greater assurance that the target retirement fund's asset allocation will not be subject to "style drift".
  - Minimizes the fiduciary's need to monitor the investment performance of the underlying funds.
- 3) A fiduciary should also ensure that due diligence is performed in selecting a fund family (or families) from which to draw a plan's target retirement date funds. The new Morningstar system should make this more useful, but this system is evolving, and like the current Morningstar rating system has its limits. It is very important that a plan develop, adopt, and maintain an Investment Policy Statement (IPS) that can then outline some of the criteria that will be used for selection and ongoing monitoring of all plan funds by the fiduciaries or investment committee.
- 4) As noted above, there is also an issue with education. It should be noted that target retirement funds, while "simple", may actually introduce an additional level of employee education. Participants need to understand their investor type (whether or not they are an "average" risk taker), how to incorporate their other investments into their investment decisions, when they will need to start withdrawing their money, etc. There is a lot to consider, and the fiduciary who thinks that the plan's education efforts can be stepped down as a result of offering target retirement date funds is in unsafe territory.
- 5) Finally, fiduciaries should be sure they are asking the right questions and are looking at how the employees actually use the plan. For example, if a typical terminated employee takes his money out of the plan right away at termination, he may have been better off in a different fund than one that takes into account a retirement date many years into the future.

It should not be overlooked that there are providers and investment advisors who create their own target retirement "portfolios" from the menu of mutual funds offered to all plan participants. These are often pre-mixed portfolios of non-proprietary mutual funds. This can give fiduciaries the additional assurance that the target retirement offerings are incorporating mutual funds from several different fund companies, and are not saddled with a handful of a single fund company's poorer performers. It should be cautioned; however, that such a portfolio is most effective when taking a passive investment approach, for reasons outlined above.

When designing an automatic enrollment feature for a given plan, the same pros and cons should be carefully considered. Even in this “autopilot” environment, in deciding on a default fund or funds, plan fiduciaries are making a decision that has significant bearing on the ultimate retirement success of employees. Target retirement date funds can be very useful in this context, if properly selected and applied.

There are other, effective approaches to providing an easy investment choice for participants. Lifestyle funds or portfolios, for example, are purely risk based, and a proper education program can be very straightforward and guide participants in how to match up a fund or portfolio with his risk tolerance, and how to modify an election as he progresses through his career. This sidesteps some of the confusion in educating participants on varying from the average risk tolerance built into a target retirement date fund. It is also more straightforward to take into account outside investments with this approach.

## What can we expect in the future?

One thing seems certain – as the industry evolves, the fallout from the 2007-2009 recession continues, and the DOL and SEC sift through the results of their public hearing, there eventually will be more regulation and better tools for the objective evaluation of these funds. Even if no consensus develops among providers, there will probably be more disclosures that can help the prudent fiduciary select target retirement date funds. Fund companies should refine and clearly define what they are offering, and what risks are involved. Target retirement date funds are here to stay, as evidenced by recent growth in assets in these funds, and the industry will have to provide more information as demanded by the users of these options. Another virtual certainty is the continued evolution of the funds themselves, to include more asset classes, glide paths that take distributions into account, etc.

Unfortunately, improved tools and regulation will not make a plan fiduciary’s job much easier. It is still very important to consider all of the issues involved – which no tool can adequately capture. It is therefore of supreme importance to not see these funds merely as a means to make the plan fiduciary’s investment education role easier, but as an opportunity to help the plan’s participants attain a more secure retirement—given the right funds, the right application, and the right education. In this context, they can be a very useful investment vehicle.

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