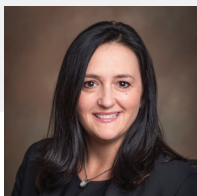




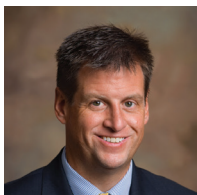
## **PRICE PERSPECTIVE**

May 2018

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Lorie Latham, CFA  
*Senior DC Strategist*



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Services*

# An Evolving Target Date Landscape. **INSIGHTS TO AN INFORMED ASSESSMENT PROCESS.**

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## **EXECUTIVE SUMMARY**

- The increasing reliance on target date funds (TDFs) as the core defined contribution (DC) offering designed to help participants achieve successful retirement outcomes has resulted in exponential growth in assets and participant use, an evolving landscape of offerings, and increased regulatory scrutiny and guidance in the selection and monitoring of TDFs. This leaves plan sponsors with the complex task of assessing TDFs for an approach that not only meets their plan needs, but that is also aligned to their governance capabilities.
- Sponsors should carefully consider the value proposition that different target date approaches offer, including the potential benefits to participants, alignment to plan objectives, and the value-for-fee proposition. Defaulting to the least expensive offering is not a thorough process and does not ensure the participants' needs are met. It also does not guarantee protection against claims of fiduciary liability, which we believe is misunderstood in the marketplace today.
- We believe a clear framework designed to inform TDF decisions—one that takes into account a plan's specific objectives, characteristics, risk preferences, and governance capacity—can help sponsors make prudent decisions when evaluating a TDF implementation approach.
- This paper offers a framework for sponsors to establish a belief set and clarity of governance structure that provides sponsors a solid foundation to inform their review and selection of a specific TDF solution.

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Given the growing importance of target date funds in defined contribution retirement plans, it's not surprising that many plan sponsors are carefully evaluating their TDF offerings.

As fiduciaries, DC plan sponsors are required to be prudent investors and make all investment decisions based solely in the best interest of the plan's participants. In fulfilling that role, sponsors face scrutiny from

many parties, including policymakers, regulators, and participants. Adding to the complexity of their task is the fact that the provider community now offers a diverse spectrum of target date solutions. Although this diversity enables sponsors to select the solution that they believe best matches the specific needs of their participants, it also adds complexity and can complicate the due diligence process.

In this paper, we offer a framework of guiding principles that we believe can help plan sponsors make more informed decisions when evaluating and selecting target date solutions and choosing among target date implementation options.

## THEN VERSUS NOW

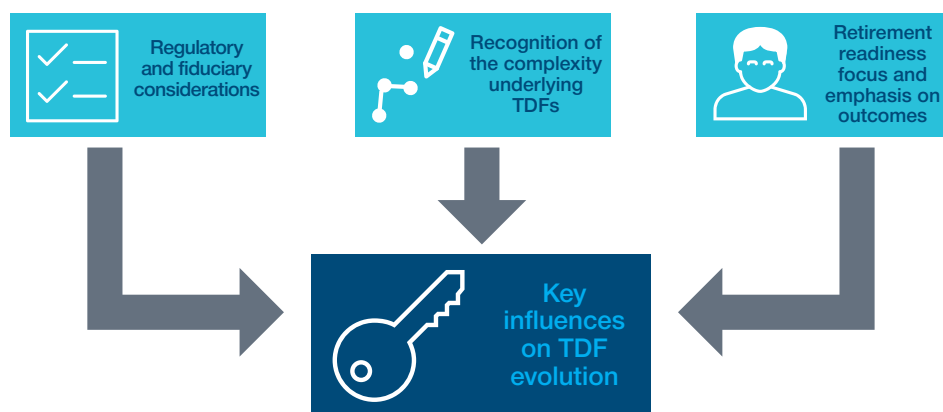
The 2006 Pension Protection Act (PPA) laid the foundation for a smarter way to deploy DC assets on behalf of participants by allowing plans to designate a qualified default investment alternative (QDIA). Post-PPA target date solutions have become a foundational investment offering for a growing number of DC plans, as evidenced by the analytics below:

- Target date assets account for 19% of U.S. 401(k) plan assets.<sup>1</sup> Some studies show that more than 90% of DC plans have a QDIA as a default investment fund and 85% use TDFs as the QDIA.<sup>2</sup>
- TDF assets in 401(k) plans are projected to surpass \$2 trillion by 2020 and could make up more than 70% of 401(k) plan contributions.<sup>1</sup>
- According to Willis Towers Watson, 80% of Fortune 500 companies now only sponsor a DC plan as a primary source of private retirement income.<sup>3</sup>

These statistics reinforce the fact that asset managers and advisers need to partner with plan sponsors to ensure they are making the best and most informed decisions for their participants.

The DC industry has progressed in how DC plans are approached, sharpening the focus on how decisions are made and the influences that sponsors should consider when structuring their plan's investment offerings. Since PPA, we've seen shifts in the landscape of DC offerings as well as increased clarity

**FIGURE 1: Key Influences Shaping TDF Evolution**



Source: T. Rowe Price.

about sponsor oversight responsibilities and the considerations when selecting and monitoring TDFs.

As the DC industry, and by extension the TDF segment, has matured, a range of ways to approach TDF implementation has evolved. These alternatives include bundled target date offerings, which offer comprehensive, one-stop implementation, as well as customized solutions that unbundle the implementation components and are generally tailored to plan specifications. Sponsors must also make decisions about a multitude of other TDF implementation factors, such as the shape of the glide path, the underlying asset class exposures, and the choice of investment management techniques—whether active, passive, or a combination of both approaches.

## INFLUENCING A CHANGING LANDSCAPE

Before outlining what we believe to be a useful framework for plan sponsors evaluating their TDF offerings, it is helpful to review some of the key influences that have impacted the evolution of TDFs and therefore the range of offerings available today (Figure 1, above):

- 1. Regulatory Focus:** A culmination of events led the Department of Labor (DoL) and Securities and Exchange Commission (SEC) to provide guidance for fiduciaries and investors. The extreme market volatility seen during the 2008 financial crisis—such as the 37% loss on the S&P 500 Index in 2008 and the subsequent 26.5% gain in 2009—marked an inflection point in how regulators, sponsors, and the investment industry view TDFs. In the wake of the crisis, there has been a keener awareness that TDFs, while diversified, are subject to market fluctuations and do not provide a minimum asset threshold or guarantee. The crisis also raised awareness of the significant differences in glide paths and underlying asset class exposures among TDF providers. These factors, in part, led to an SEC bulletin titled *Investor Bulletin: Target Date Retirement Funds* to investors in 2010 that illuminated the risk/reward trade-offs inherent in TDFs and stressed the importance of understanding the investment objectives of the TDF solution and the range of possible outcomes. The bulletin emphasized that TDFs do not guarantee that participants will be

<sup>1</sup> The Cerulli Report: U.S. Defined Contribution Distribution 2016: Engaging the Boutique DC Consultant in the Mid-Sized DC Plan Market—Projected 401(k) Target-Date Assets and Contributions, 2015–2021E.

<sup>2</sup> Callan, 2016 DC Trends.

<sup>3</sup> Willis Towers Watson, *Insider*, Volume 26, Number 3, March 2016.

able to achieve sufficient retirement income. In 2013, the DoL published a set of tips for plan sponsors of all sizes that underscored the need to examine and monitor TDFs in a comprehensive manner (see appendix). While these tips did not constitute formal regulatory guidance, they suggested a series of steps for plan sponsors to assess TDF offerings.

## 2. Recognition of TDF Complexity:

TDFs encompass a diversified set of asset class exposures and underlying investment strategies that change over time as the fund moves along its glide path. The specific implementation of each plays an essential role in the risk/reward profile of the overall portfolio. Accordingly, sponsors need to have a clear understanding not only of the overall TDF portfolio structure, but also of the underlying strategies and/or other investment vehicles in each allocation. This knowledge is especially critical if the target date offering is also the plan's QDIA. Although the ability to "set and forget" portfolio allocations is a key advantage of target date offerings, that benefit should only apply to participants.

**3. An Emphasis on Outcomes:** Now that DC plans have become the most important source of retirement funding for many if not most private sector employees, the focus of plan evaluation has moved beyond asset accumulation to encompass the entire retirement life cycle: growing assets, transitioning assets into retirement, and generating sustainable income throughout retirement. As a result, the DC industry is seeking to establish a more robust outcome-oriented framework for measuring success, one that moves away from a single-minded focus on account dollar value at retirement—which by itself is suboptimal for participants.

These influences have evolved the way many sponsors approach their target date offerings. The spectrum of options available in the marketplace has expanded, as have the possible steps to evaluate TDF options.

One valuable step for sponsors is to periodically assess their current TDF offering and determine whether it is aligned to plan needs and objectives. Such an exercise can help document the fact that a diligent and prudent assessment process has been followed.

## A FOUNDATION FOR EVALUATION

The role of a plan sponsor is complex, and sponsors often find themselves facing the reality that any course they choose presents both opportunities and risks, and every decision they make may involve the exchange of one risk for another. While every decision in a DC plan is important, the selection of the QDIA stands out based on its use as the default and corresponding reach and potential impact on participant outcomes.

The analytical framework outlined in Figure 2A, on page 5, may be helpful for plan sponsors as they begin the process of evaluating the target date options available in the marketplace. This framework summarizes some of the overarching issues that sponsors may need to consider in assessing whether a given TDF implementation option is well aligned with their plan's needs. This framework may be an affirmation or an update of what is already known for some sponsors, and for others it may be a new process altogether. The key steps in that process are:

- **Define the role of the plan and the TDF:** The framework's first step in evaluating investment options—including TDF offerings—is to understand and frame the plan's purpose, mission, and objectives and how these considerations impact the role of the TDF. These factors will

influence how sponsors assess the available implementation options and ensure that the TDF offering aligns to the objectives of the plan.

## Key Questions:

- Is the plan the primary or a supplemental retirement savings vehicle?
- Does the plan exist to be an accumulation vehicle or also to manage income in retirement?
- Does the committee want plan design features that encourage employees to retain or distribute assets after they leave?
- How does the plan fit into the broader context of benefit programs?
- What role does the TDF play in the plan's purpose?

- **Factor in participant demographics and behaviors:** Sponsors should also consider taking into account participant characteristics such as average salaries, contribution levels, plan participation rates, and workforce turnover, as well as behavioral factors such as tolerance for market volatility and desired investment time horizons. These factors can help sponsors determine if the expected levels of risk exposure in the glide path are appropriate for their plan.

## Key Questions:

- How robust are employer contribution levels?
- What is the employer's contribution match formula?
- Does it encourage a fairly high/low deferral rate?
- Do employees defer a high/low percentage of their salary?

■ **Develop views on key investment drivers and desired outcomes:**

Available TDF solutions offer different risk and reward profiles and components that require sponsor assessment including the glide path, asset class exposures, portfolio construction methodology, and underlying investment management (Figure 2B, page 6). Other elements for consideration include the role of tactical allocation, the need for periodic rebalancing, and the types of investment vehicles used in the underlying allocations.

**Key Questions:**

- How does the committee view and prioritize various risks such as market, longevity, and inflation risks?
- What are the committee's views on active versus passive management and/or where markets are efficient or there is opportunity to exploit market inefficiencies?

■ **Understand the committee's expertise and oversight capabilities:**

Different implementation approaches require varying degrees of investment expertise, time, and oversight capacity on the part of the sponsor's key decision makers. We believe sponsors would be wise to balance plan complexity against their ability to manage complexity.

**Key Questions:**

- How much time does the committee have to devote to investment, administrative, and operational oversight?
- Does the committee have the expertise and/or excess capacity to develop and execute a bespoke solution?
- Does the committee desire direct control or identifying partnerships to execute on their behalf?

■ **Evaluate other implementation factors:**

It is important not to overlook factors such as the types of investment vehicles (mutual funds, commingled trusts, separate accounts, etc.) available for specific investment offerings and ensuring that sponsors are maximizing their plans' scale and buying power.

**Key Questions:**

- Does the plan have other asset pools that can be leveraged?
- Can the plan leverage its scale to access different vehicle types?
- What capabilities do the plan's providers have to implement?

Investment committees that complete these steps can gain clarity and conviction in assessing the options available to them and will have a framework to reference for selection and ongoing monitoring of a target date solution.

**A BUNDLED OR CUSTOMIZED SOLUTION?**

Once plan sponsors have asked these questions, they can begin to decide what type of solution to offer: bundled or custom. For many DC plan sponsors, bundled target date products may be an attractive option, as the complexities of the TDF and its underlying components are both managed by a single investment partner. Providers offering bundled target date solutions develop the entire investment framework outlined on page 6—including setting the glide path; determining the strategic asset allocation (and, if appropriate, any tactical allocation process); and managing the underlying investment vehicles using active management, passive management, or a combination of both.

A bundled approach offers advantages for the vast majority of sponsors who do not wish to unbundle each of the decision points associated with TDFs. However, sponsors retain the ultimate responsibility

for the TDF offering and must ensure it is prudently and appropriately managed, both in the initial provider selection process and ongoing monitoring.

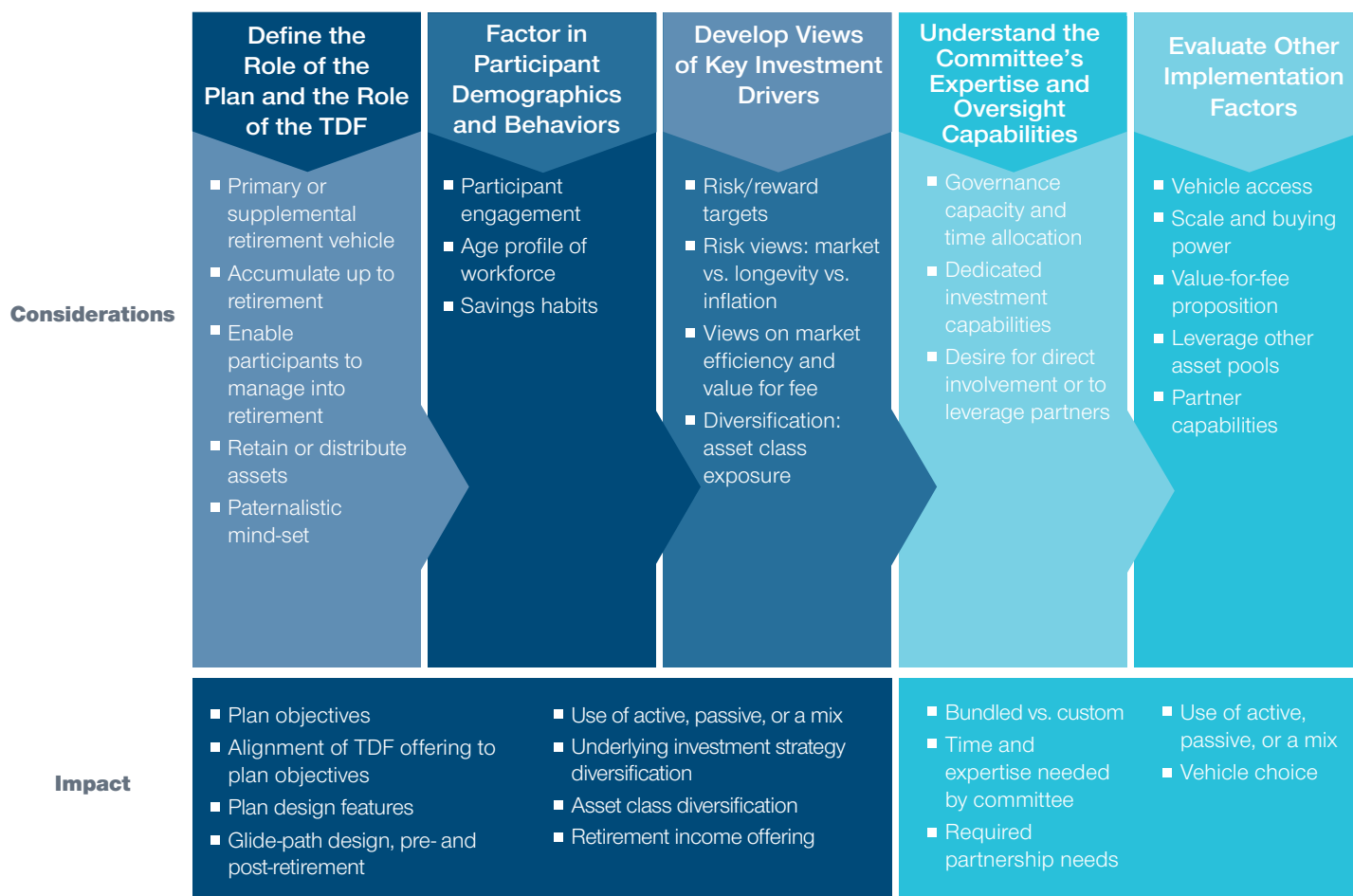
Alternatively, plan sponsors with strong in-house governance and oversight capabilities may opt to partner with a provider to develop customized target date offerings. Customized programs can be tailored to specific plan needs, and the sponsor retains direct control over the underlying components. Given that a diverse array of glide paths are available in the marketplace from bundled providers, customized offerings most typically are preferred when the sponsor wishes to retain the ability to select the underlying asset managers—perhaps to utilize managers that are already in the sponsor's defined benefit or defined contribution plan lineup. Sponsors can benefit from working through some of the underpinnings and evaluating early on if a bundled solution helps them achieve their needs or if custom offering is a feasible pursuit. Sponsors benefit by narrowing their preferred approach before evaluating specific offerings so that the comparison of providers is a level playing field and reduces confusion, and avoids an overwhelming and even cluttered assessment process.

**MEASURING SUCCESS**

The focus today is evolving toward a more holistic assessment of retirement. This has direct application to how to evaluate a TDF and there are a variety of metrics linked to outcomes that can be part of the assessment of a TDF solution. These metrics may include income replacement ratios based on a defined set of savings and asset growth assumptions; drawdown scenarios and the probability of success; or a range of possible performance results that include extreme market conditions, both upward and downward.

Sponsors need to recognize that assessing the performance of their TDF offerings is a more nuanced process

**FIGURE 2A: Underpinnings to Develop Informed Views When Assessing TD Approaches**



Source: T. Rowe Price.

than it is for other investment options. TDF investment performance related to risk and return should be evaluated relative to the TDF's objective and level of diversification. In addition to evaluating top-level performance, plan sponsors may evaluate the contributions to risk and return made at each level of the portfolio construction and implementation process.

When assessing TDF offerings, most sponsors now are complementing traditional performance evaluation with expanded metrics. These may include quantifying how diversification decisions may influence performance in different market environments and depending on

what specific asset classes or sectors are in or out of favor. As mentioned earlier, drawdown metrics, replacement ratios, and probabilities of success may all be considered along with performance.

#### **THERE IS NO SINGLE RIGHT ANSWER**

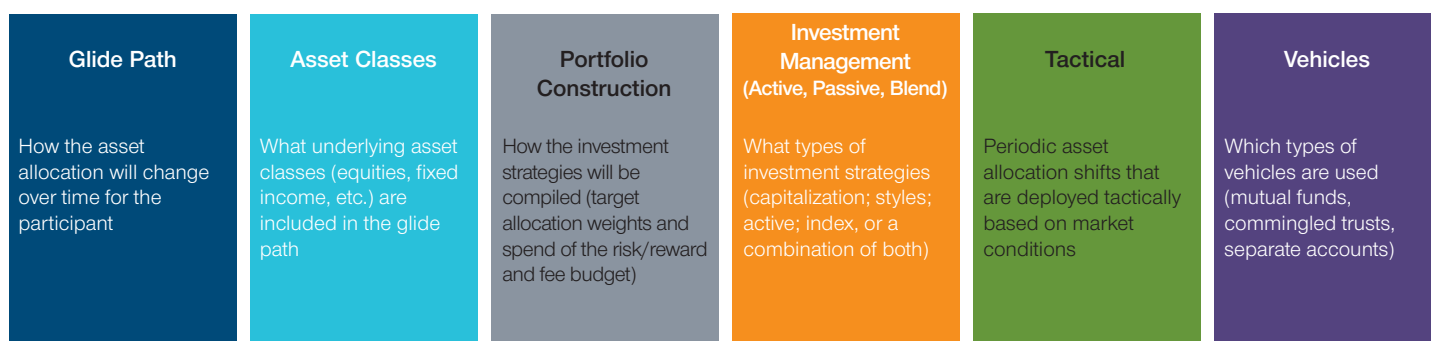
In enforcing the Employee Retirement Income Security Act (ERISA), the DoL does not assess plan compliance based on end results such as performance, nor does the department suggest that the lower-cost offering is the best offering. Rather, the DoL's focus is on the process that sponsors follow in arriving at decisions in provider selection and ongoing monitoring.

We believe all of the TDF implementation choices currently available to sponsors have merit and can play useful roles in a DC plan. However, it is imperative that sponsors evaluate each option relative to their specific plan needs. We believe it is essential that sponsors avoid "fear-based" decisions based on a misperception of fiduciary risk. Rather, a more productive focus is for sponsors to base their implementation approach on a prudent process that defines plan needs and carefully documents all decisions and the influences that shaped those decisions.

Cost is one of the key factors sponsors need to consider when assessing TDF solutions; however, it should not be the



**FIGURE 2B: Underlying Target Date Investment Components Influenced by Figure 2A**



Source: T. Rowe Price.

key driver. Sponsors must be astute in evaluating the entire value proposition presented by an implementation option—the potential benefits for plan participants as well as costs. Defaulting to the cheapest option does not provide a free pass in terms of fiduciary liability. As one legal expert has noted: “Courts have consistently recognized that fees are just one dimension to a plan’s investments and should not alone be the basis upon which an investment selection decision is judged.”<sup>4</sup>

Unfortunately, DC plans have become a focus of recent litigation and plan sponsors are an unwitting target of these activities. The way to combat this risk is to develop a clear and well-documented process that governs the evaluation, selection, and monitoring of all DC investment options, including TDF offerings. The downside of fear-based decision-making is that sponsors may lose sight of outcomes and fail to provide participants access to offerings that are well positioned to lead to better long-term outcomes.

## CLOSING THOUGHTS

TDFs have served participants well in establishing well-diversified portfolios positioned for long-term successful outcomes. However, we have witnessed a dramatic evolution of the TDF market over the last decade and repeated signals from the regulators that sponsors must exercise good governance oversight of investment solutions.

Additionally, the range of participant needs and level of complexity in the design and selection of the TDFs reinforces the need for sponsors to apply a prudent process in evaluating investment offerings. We believe that the high-level framework outlined in this

paper offers sponsors key underpinnings to establish a belief set that will support making informed and prudent decisions when assessing the various approaches to target date solutions offered in the marketplace. Plan sponsors can leverage the insights developed through this work as a foundation to inform how they assess, select, and monitor specific TDF offerings and implementation approaches.

## KEY TAKEAWAYS

- Sponsors need to understand the landscape of TDF offerings available in the market today.
- Sponsors should take the opportunity to develop key beliefs that will inform how they assess TDF approaches available in the marketplace.
- Sponsors should apply a prudent and diligent process to the tasks of assessing and monitoring TDF offerings.
- Selection and monitoring of TDFs should be based on alignment to plan objectives.
- Cost is only one of several factors that sponsors need to consider when assessing TDF solutions and should be considered within a value-for-fee proposition.
- Sponsors should carefully document all aspects of their TDF investment process.

<sup>4</sup> Douglass, Alison V., The Misperception of Fiduciary Risk and Active Management in DC Plans: A Legal Perspective, 2017.

**APPENDIX: TIPS FROM THE DEPARTMENT OF LABOR**

In 2013 the Department of Labor published general guidance for plan sponsors to consider when selecting and monitoring target date offerings. These tips include:

- ✓ Establishing a process for comparing and selecting TDFs.
- ✓ Establishing a process for periodic review of selected TDFs.
- ✓ Understanding the fund's investments—the allocations to different asset classes (stocks, bonds, cash), the underlying investment strategies, and how they change over time.
- ✓ Reviewing the fund's fees and investment expenses.
- ✓ Inquiring about whether a custom or nonproprietary TDF would be a better fit.
- ✓ Developing effective participant communications.
- ✓ Taking advantage of available information to evaluate TDFs and the recommendations sponsors have received regarding TDF selection.
- ✓ Documenting the process.

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