401(k) Fiduciary Focus: Target Date Funds

By Lee Applebaum, CFP®, CRPC®, AIF®

Target Date Funds (TDF) have become an extremely popular investment choice in 401(k) plans over the years (and is the default investment option in many plans), but it has been our experience that neither employees nor employers know enough about them to make a well-reasoned determination if they are appropriate. As a quick definition, a target date fund is an investment that is easily identified by a year in its name (2010, 2020, 2030, etc.) The year relates to the closest year in which the employee turns age 65. The theory being that the TDF is a one stop diversified portfolio that gets progressively more conservative as the employee gets closer to retirement (the target date).

The Investment Company Institute and Vanguard conducted studies recently and have found that target date funds presently represent approximately 25% of all 401(k) plan assets and are expected to account for almost 50% of retirement plan assets by 2020. A major concern with TDF's is that most employees and employers do not know the investment philosophy of the underlying investments. As an example, in 2008, the average 2010 fund (in theory where a 63 year old investor within 2-3 years of retirement would have had their money) lost on average 25%. To put that in perspective, the broader markets like the S&P 500 lost 37%. Would you think that the average 63 year old would have been willing, if known all the facts, to risk losing potentially ¼ of their retirement money so close to retirement? I would argue no. How did this happen? How could this be avoided? The answer is to understand a concept called a glidepath.

The glidepath is the asset-allocation mix over the years and shows what level of equities the fund holds at each specific age. Understanding the glidepath of the TDF is the key to determining if the fund is appropriate for the plan. TDF's are broken into two categories "to" or "through;" simply meaning, they invest "to" retirement, or "through" retirement. Understanding this concept, one could see why the average 2010 TDF lost 25% in 2008; at the time, most TDF's were "through" retirement products. Back then, it wasn't uncommon to have a 2010 fund with 50% to 60%or more in equities. If you look under the hood today, a 2015 TDF (once again, appropriate for someone age 63) can range in equity allocation from 20% to almost 80%! If a TDF fund is considered a "to" fund, at the target year (the year the employee turns 65), the fund will be at its most conservative – probably 20% to 25% equity and will stay that way indefinitely. On the other hand, a "through" fund will not be its most conservative until a much later time; usually age 80 or older, so at age 65 (the target year), the fund could have 50%+ in equities.

In 2007, the Department of Labor (DOL) ruled that plan sponsors (business owners, investment committees, CFO's, etc.) who are fiduciaries on 401(k) plans must go through a deliberate, prudent process in determining which TDF to place in a 401(k) plan. They stated that fiduciaries must "act prudently and solely in the interest of

the plan's participants and beneficiaries" and must "engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate." Simply stated, the DOL is telling us that if you have a 401(k) plan with XYZ vendor, you can't just place the XYZ target date fund in the plan and be protected fiduciarily. This is what our firm sees over and over again; a proprietary TDF inside a 401(k) plan, and many times these funds are "through" retirement funds and the plan fiduciaries do not know their responsibility of prudence and due diligence. In 2009, after a request from Marcia Wagner from the Wagner Law Firm in Boston, the DOL released Bulletin 2009-04A, which even further clarified a plan fiduciary's responsibilities related to target date funds.

Also in 2007, McKinsey & Company released a study and found that 85% of respondents chose "guaranteeing an income for retirement" as a top concern. Another 45% also chose "protecting against markets risks." The fear and risk aversion they found appears to be a direct result of the economic crisis that was just beginning to rear its ugly head. As a result, some TDF families are beginning to incorporate a guarantee feature as part of their funds; but like everything else, *caveat emptor*. Not all guaranteed products are created equal, and fiduciaries must perform their due diligence to evaluate fees and levels of protections to determine what (if any) guaranteed product is appropriate for their employees.

If you as a plan fiduciary decide that a TDF is something you want to offer to your employees, you must go through a deliberative process to determine what is appropriate based on employee demographics. More than likely, employees in a machine shop will have a different investment philosophy than a specialty medical practice. There are several tools available to query the business owner to determine if "to" or "through" retirement is appropriate, and this is something that should be performed and documented. Hiding under a rock and placing a plan provider's proprietary TDF in a plan is potentially a violation of ERISA and could possibly land a fiduciary in court when we have another 40% or more drop in the markets.

I hope you now understand that blindly choosing a target date fund or just relying on the 401(k) vendor to place their own proprietary fund is fraught with potentially serious fiduciary implications.

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