TARGET DATE FUNDS

TIPS FOR ERISA PLAN FIDUCIARIES FROM THE DEPARTMENT OF LABOR

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At the end of February, the U.S. Department of Labor Employee Benefits Security Administration (EBSA) issued general guidance to assist plan fiduciaries with selecting and monitoring target date funds and other investment options in 401(k) and similar participant-directed plans. The fact sheet titled, "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries", quickly garnered attention and press, not all of it favorable.

While some regulatory oversight of target date funds has been expected since large losses in the funds appeared to surprise investors and regulators alike in 2008, the EBSA document didn't propose any new rules for target date funds. In fact, the three page fact sheet wasn't very technical at all, starting with a section titled "Target Date Fund Basics", and then moving to the section we've reprinted in this paper titled, "What to Remember When Choosing Target Date Funds". So why all the fuss about the document? Namely, EBSA did not follow a typical regulatory process in which language is proposed and a comment period follows, and in the document EBSA guides plan fiduciaries to identify, among other things, whether custom or non-proprietary target date funds would be a better fit for their plan (see bullet five of eight).

For many, the fact sheet merely suggests that there are a range of products, and sponsors need to consider how particular products suit their needs. It is not clear that EBSA was being critical of plan sponsors that offer the proprietary target date funds of their 401(k) record keepers or of fund managers that use only proprietary funds in their target date offering. Others clearly felt differently. Within days, the Groom Law Group commented they were "surprised and a little disturbed" by the DoL's guidance around TDFs. In their view the DoL is understating the costs and tasks associated with adopting custom or non-proprietary TDFs and putting plan sponsors and providers on the defensive.

"The DoL's document guides plan fiduciaries to identify whether custom or non-proprietary target date funds would be a better fit for their plan"

In our role as Consultants, we think it's best to bring the EBSA guidance—as written—directly to plan sponsors. If we think of the document as a checklist, in our view our clients are already doing the right things today. They select their target date funds through competitive bidding processes, they evaluate the funds and fees regularly, and a good number of them offer custom target date funds. In that regard, EBSA's fact sheet is, on the whole, helpful and supportive, and may encourage more sponsors to migrate to custom target date funds over time.

Below we've reprinted without alteration EBSA's guidance on selecting target date funds for your program

What to Remember When Choosing Target Date Funds

- **Establish a process for comparing and selecting TDFs.**

In general, plan fiduciaries should engage in an objective process to obtain information that will enable them to evaluate the prudence of any investment option made available under the plan. For example, in selecting a TDF you should consider prospectus information, such as information about performance (investment returns) and investment fees and expenses. You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates. It also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns.

- **Establish a process for the periodic review of selected TDFs.**

Plan fiduciaries are required to periodically review the plan's investment options to ensure that they should continue to be offered. At a minimum, the review process should include examining whether there have been any significant changes in the information fiduciaries considered when the option was selected or last reviewed. For instance, if a TDF's investment strategy or management team changes significantly, or if the fund's manager is not effectively carrying out the fund's stated investment strategy, then it may be necessary to consider replacing the fund. Similarly, if your plan's objectives in offering a TDF change, you should consider replacing the fund.

- **Understand the fund's investments – the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time.**

Have you looked at the fund's prospectus or offering materials? Do you understand the principal strategies and risks of the fund, or of any underlying asset classes or investments that may be held by the TDF? Make sure you understand the fund's glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date. Some funds keep a sizeable investment in more volatile assets, like stocks, even as they pass their "target" retirement dates. Since these funds continue to invest in stock, your employees' retirement savings may continue to have some investment risk after they retire. These funds are generally for employees who don't expect to withdraw all of their 401(k) account savings immediately upon retirement, but would rather make periodic withdrawals over the span of their retirement years. Other TDFs are concentrated in more conservative and less volatile investments at the target date, assuming that employees will want to cash out of the plan on the day they retire. If the employees don't understand the fund's glide path assumptions when they invest, they may be surprised later if it turns out not to be a good fit for them.

- **Review the fund's fees and investment expenses.**

TDF costs can vary significantly, both in the amount and types of fees. Small differences in investment fees and costs can have a serious impact on reducing long term retirement savings. 2 Do you understand the fees and expenses, including any sales loads, for the TDF? If the TDF invests in other funds, did you consider the fees and expenses for both the TDF and the underlying funds? If the expense ratios of the individual component funds are substantially less than the overall TDF, you should ask what services and expenses make up the difference. Added expenses may be for asset allocation, rebalancing and access to special investments that can smooth returns in uncertain markets, and may be worth it, but it is important to ask.

- **Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan.**

Some TDF vendors may offer a pre-packaged product which uses only the vendor's proprietary funds as the TDF component investments. Alternatively, a "custom" TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF. Nonproprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider. There are some costs and administrative tasks involved in creating a custom or nonproprietary TDF, and they may not be right for every plan, but you should ask your investment provider whether it offers them.

- **Develop effective employee communications.**

Have you planned for the employees to receive appropriate information about TDFs in general, as a retirement investment option, and about individual TDFs available in the plan? Just as it is important for the plan fiduciary to understand TDF basics when choosing a TDF investment option for the plan, employees who are responsible for investing their individual accounts need information too. Disclosures required by law also must be considered. The Department published a final rule that, starting for most plans in August 2012, requires that participants in 401(k)-type individual account retirement plans receive greater information about the fees and expenses associated with their plans, including specific fee and expense information about TDFs and other investment options available under their plans. The Department of Labor is also working on regulations to improve the disclosures that must be made to participants specifically about TDFs. For example, in addition to general information about TDFs, the proposed regulations call for disclosures to include an explanation that an investment in a TDF is not guaranteed and that participants can lose money in the fund, including at and after the target date. Check EBSA's website for updates on regulatory disclosure requirements.

- **Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection.**

While TDFs are relatively new investment options, there are an increasing number of commercially available sources for information and services to assist plan fiduciaries in their decision-making and review process.

- **Document the process.**

Plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options.

For More Information:

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