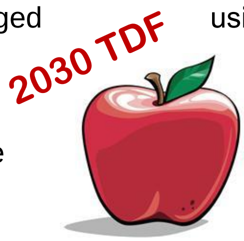
Dept. of Labor Guidance for Target Date Retirement Funds

In February of 2013 the U.S. Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) issued guidance to help plan fiduciaries in selecting and monitoring Target Date Funds (TDFs) as more employee-directed retirement plans (401k, 403b, etc.) now use TDFs to help participants select their investment allocations. Studies from DALBAR and the Employee Benefits Research Institute (EBRI) leave little doubt that participants are assisted with a professionally managed portfolio rather than choosing the investments themselves, and TDFs offer one professionally-managed solution. But plan fiduciaries face a difficult task in evaluating TDFs, like comparing apples to oranges.



A TDF is a diversified portfolio of investments allocated based upon the age of the participant. Presumably an employee retiring in the year 2050 can be more aggressive than an employee retiring in the year 2030. The benefit of the TDF is that a portfolio will become more conservative as the retirement date approaches. Conversely, the limitation of the TDF is the assumption that everyone retiring in a particular year has the same risk tolerance. But the challenges are even greater for plan fiduciaries who must choose which TDF to make available to their employees.

The difficulty is that TDFs are built differently and the name is not always descriptive. For instance, one 2030 TDF can reach its most conservative allocation in the year 2030, but another can reach its most conservative allocation in the year 2035 or 2040 or even 2060! The TDF that is on this longer glide path is using a "through" strategy, and while the returns might be higher the subsequent risk for participants might not be appropriate. The TDF using a "to" strategy positions the glide path to reach the most conservative allocation at the retirement date.

Comparing different TDFs is now possible with the new evaluation tools yet many plan fiduciaries are still not utilizing the tools at their disposal. The typical retirement plan committee spends more time evaluating the core funds than the TDFs even when the majority of plan assets are in the TDFs.

There are a number of reasons why TDF evaluation tools are under-utilized. One reason is that these tools are only available to retirement plan professionals and not to plan sponsors, so the plan's advisor must initiate their use. But another reason is that evaluations lack meaning on platforms where choices are limited and/or proprietary.

In fact, one of the biggest mistakes a retirement plan committee can make is simply accepting whatever TDFs the platform provides. Since some platforms are also investment managers they will generally promote their own proprietary TDFs. Their own TDF may or may not provide the best solution. Another related mistake that some committees make is not understanding the TDF they were given. Is it "to" or "through"? One size does not fit all. And then committees make the mistake of not evaluating the TDF, which is noncompliance with the DOL guidance offered in 2013.

The DOL guidance provides 8 tips for selecting and monitoring TDFs. The first tip is to "Establish a process for comparing and selecting TDFs." † According to the EBSA the process needs to be "objective" † which means not influenced by the service provider. It also needs to be suitable for that particular employee population.

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† – "Target Date…Tips", DOL, Feb. 2013

The second tip is to "Establish a process for the periodic review of selected TDFs." † According to the EBSA, one possible outcome of this regular review is to "consider replacing the fund"† which implies plan fiduciaries should have flexibility rather than limits from their service provider on fund choices.

The third tip is "Understand the fund's investments – the allocation in different asset classes (stocks, bonds, cash) individual investments, and how these will change over time." † Plan fiduciaries need to "understand the fund's glide path, including when the fund will reach its most conservative allocation." †

The fourth tip from the DOL is "Review the fund's fees." † Are there additional fees for that portfolio or is the cost simply the underlying expense ratio of each of its holdings? The point is not to simply choose the lowest cost option but to be mindful of unnecessary expenses. After all, the returns are net of each expense ratio so if a fund with a higher fee delivers a better return the fee could be justifiable, but plan fiduciaries should understand this. According to one report from the EBSA, even a 1% difference in fees can mean as much as a 20% difference in returns over the lifetime of the plan.
["A Look at 401(k) Plan Fees" at http://www.dol.gov/ebsa/publications/401k_employee.html]

According to the EBSA, plan fiduciaries should "Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan." † The "pre-packaged product which uses only the vendor's proprietary funds" † may not be appropriate.

TDF Tips from the EBSA

1. **Establish a process**
2. **Review periodically**
3. **Understand the TDFs**
4. **Review the fees**
5. **Ask about options**
6. **Communication**
7. **Use evaluation tools**
8. **Document everything**

The DOL avoids recommending any particular TDF, of course, as well as recommending any particular TDF strategy (to vs. through) but the EBSA says that it is critical to "Develop effective employee communications" † so that the plan participants understand which strategy their plan's TDF is using. In other words, it isn't right or wrong to use a "to" or "through" but it is wrong to use a "through" strategy that's misunderstood to be a "to" strategy. Making sure that employees understand the TDFs is the sixth tip and possibly the most important if judged merely by the amount of attention the EBSA devotes to this point.

The seventh tip for plan fiduciaries using TDFs is "Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection." † As noted above, there are now at least three different TDF evaluation tools and the EBSA encourages plan sponsors to use such a tool. Since these tools are only available through the plan advisor it is crucial to hire a proactive advisor.

And the final tip is the golden rule for all Due Diligence procedures for plan fiduciaries: "Document the process." †

As more participants use TDF portfolios the burden to properly evaluate these options increases for plan fiduciaries, and under the DOL guidance retirement plan committees need to scrutinize these investment options at least as seriously as they do their other funds.

For questions or information regarding any of this material, please contact us directly.

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