The Benefits of Tailored Target-Date Funds

Custom target-date funds may offer plan sponsors greater flexibility, control over investment selection, and better alignment with participant demographics and retirement income needs. Here’s what plan sponsors should know when considering custom versus off-the-shelf target-date funds for their defined contribution (DC) plans.

It’s no surprise that target-date funds now garner a significant — and growing — portion of the DC plan market. As we have reported in past issues of Planet DC, target-date funds have become the most common qualified default investment alternative (QDIA), and an increasing number of companies now auto-enroll new hires (and re-enroll existing employees) into the investment option as the QDIA, driving the rise.
The Rise of Custom

While “off-the-shelf” (proprietary or pre-packaged) target-date funds are an acceptable choice for many plans, custom target-date funds are gaining traction, surging 18.6% to $154.5 billion in DC assets due in part by the Department of Labor’s (DOL) “Tips for ERISA Plan Fiduciaries” from 2013, which stated that plan sponsors should “inquire about whether a custom or non-proprietary target-date fund would be a better fit for your plan.”

Although it was not formal guidance, plans have begun to review the unique characteristics and appropriateness of their respective target-date fund strategies by:

- Analyzing participant demographics (including salary levels, employee turnover rates, contribution rates, contribution withdrawal patterns and whether other retirement plans are offered)
- Assessing existing glide paths for their ability to meet their participants’ retirement income needs in an era of increasing longevity
- Reviewing overall asset allocation and investments

Tailored to Participant Demographics

The industry’s increasing focus on the effectiveness of a plan’s investment options in meeting projected participant income-replacement ratios at retirement is another key factor driving the custom approach. Often viewed as a “one-size-fits-all” retirement solution, off-the-shelf target-date funds do not address the unique characteristics of a plan’s participant profile and investment limitations, such as risk tolerance, required replacement ratios, income during working years, saving rates, out-of-plan assets and expectations for Social Security income.

Custom target-date funds provide the plan sponsor with the opportunity to select the glide path and underlying funds within an open architecture framework, allowing for a blend of active and passive management if desired. The plan sponsor can also incorporate their own views and circumstances into the construction of the glide path. Plans of all sizes are now considering custom target-date funds as a flexible, bespoke option to better reflect the profile of their participants and the plan sponsors’ unique investment beliefs.

When determining whether a custom target-date fund strategy is a more appropriate fit than an off-the-shelf solution, plan sponsors should partner with the plan administrator and retirement advisor/consultant to perform in-depth analysis of the plan’s participant demographics and behavioral patterns (including average savings rate, size of account balances, current/future earnings power and investment sophistication) for various cohorts; for example, grouping via active/inactive status or 5- to 10-year age groups.

With the data in hand, discuss, decide and document the following:

- The proper slope of the glide path’s asset allocation in seeking to meet projected retirement income needs: How conservative or aggressive should it be given the plan’s participant characteristics?
- The implementation of asset classes by style (active, passive or both), strategy and vehicle type (collective investment trust, separate account or mutual funds), as well as by investment manager.
- The appropriateness of underlying asset classes and specific investments to achieve proper diversification.

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Increased Flexibility and Control

A benefit of a custom fund over a pre-packaged, proprietary option is that plan sponsors have direct control (and increased flexibility) over plan investment strategy, investment management selection and glide path construction in an open architecture environment. For example, core fund options can be pooled together in different proportions to build funds that may better match plan demographics, or the custom fund could mix and match investment strategies from the core lineup with outside strategies that could help with investment goals or seek to mitigate investment risks. The flexibility of a custom strategy gives the plan sponsor the ability to replace underperforming funds, offering increased transparency and investment oversight.

As such, a custom fund approach requires greater plan sponsor involvement and more intricate decisions. Plan sponsors assume additional fiduciary liability not only for the selection of investments but also for the investment glide path. As always, they are responsible to ensure that the investments are in sync with the objectives outlined in the plan’s Investment Policy Statement. According to the DOL’s “Tips for ERISA Plan Fiduciaries,” it is no longer prudent from a fiduciary standpoint to just go with the proprietary funds offered by the service provider in the absence of a prudent, thoughtful and well-documented selection process. Plan sponsors should determine if their plan's target-date fund characteristics, whether off-the-shelf or custom, align with eligible employees’ ages and likely retirement dates. Many plan sponsors work with a 3(21) investment adviser or a 3(38) investment manager to provide valuable guidance (or full discretion) over investment selection and monitoring.

Direct and Indirect Costs

As target-date funds in general account for more total plan assets, their larger allocation within plans can provide greater economies of scale for plan sponsors to consider offering custom funds, according to a Callan Associates report. Typically offered for larger and mid-sized plans, custom funds can give access to the “best-in-class” underlying funds, control over the glide path, and a potentially better cost structure that can exploit a plan's buying power — all significant factors. A custom series may allow for greater flexibility in cost: for example, the ability to set the plan’s fee budget. This could allow the plan sponsor or the plan’s 3(38) investment manager to selectively and affordably choose active and alternative investment strategies in asset classes where they believe it could generate improved outcomes.

Together with the plan’s retirement advisor/consultant, plan sponsors should review the direct costs of investment management (including fees for glide path design and management, day-to-day investment management, investment administration, participant communication and education) along with the indirect costs of fiduciary oversight and the monitoring of a target-date fund series as part of their due diligence.

Custom target-date funds typically require additional administration oversight. Depending on the vehicle structure, plan sponsors may need to arrange for and coordinate a variety of independent administrative services among third-party providers. It’s also important for plan sponsors to determine and consider the impact on internal resources needed to support the launch and ongoing management of a custom strategy.

In general, custom strategies will likely bear higher costs. However, while an off-the-shelf series that invests in passive funds will most likely be the lowest-cost option, it may not be the most appropriate choice for the plan’s demographic or reflect the plan sponsors’ unique investment beliefs.
Summary

Custom target-date funds may offer plan sponsors greater flexibility and investment control over investment selection, along with increased and better alignment with participant demographics and their retirement income needs. When considering custom versus off-the-shelf target-date funds, plan sponsors should work with their retirement advisor/consultant and plan administrators to perform the necessary analysis of the plan’s design and demographics and weigh the potential benefits and costs associated with both custom and off-the-shelf target-date approaches.

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