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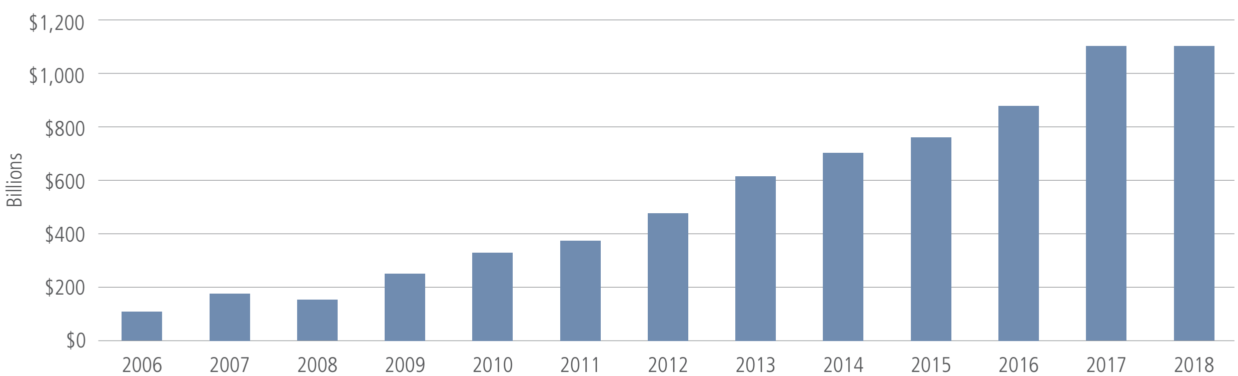
Custom TDFs Stand Out in an Aging Bull Market

Designing a QDIA option to fit plan characteristics provides multiple advantages, including the potential for effective risk management.

Target date funds have experienced a surge of growth since 2006, when the Pension Protection Act of 2006 first established them as a QDIA investment safe harbor for defined contribution plans. Far outstripping alternative choices of managed accounts and balanced funds, TDFs overall accounted for more than $1 trillion in mutual fund assets as of year-end 2018.[1] TDFs fulfill a genuine need in providing a viable default option for participants who have not chosen specific investment vehicles for their accounts, or who don't have the inclination or knowledge to choose their own funds. For plan sponsors, TDFs are relatively easy to explain to participants, and help limit liability associated with workers who may not be sufficiently prepared for retirement.

TARGET-DATE MUTUAL FUND ASSETS



Source: Morningstar. As of December 31, 2018.

However, disadvantages have become apparent as well. The vast majority of target date funds are off-the-shelf products managed by just a few mutual fund companies. Often, these TDFs are populated by the provider's proprietary funds, and the glide paths for the funds are by necessity based on broad assumptions—as to demographics, income, risk tolerance and investment goals, among other factors. The result is that a fund may work for a broad cohort, but may not be a good fit for many individual participants—particularly if a workforce varies from the "average" in a meaningful way.

[1] Source: Morningstar.

Today, another issue is emerging as well: how limited choices available in off-the-shelf TDFs could fare in an aging bull market for both stocks and bonds. Particularly, how vulnerable will underlying target date investments be to broad market movements? This includes not only "risk assets" like equities, but more conservative fixed income allocations, which increase as the target date approaches. If interest rates rebound (cutting into bond prices), where will that leave the funds? On the other side of the coin, will the fixed income allocations prove too conservative, making them more vulnerable to erosion from inflation?

Advantages of Customized TDFs

Customized TDFs provide answers to the various shortcomings associated with cookie-cutter TDFs. First, plan sponsors can draw on investments from multiple providers. This potentially allows them to choose best-of-breed managers for each asset class represented and to duplicate managers from their core menu within the TDF, which can enhance efficiency and ease of oversight. It has the added benefit of avoiding conflicts of interest around asset allocation and investment choice that may exist within a one-source provider. Importantly, the use of custom funds enables plan sponsors to implement asset allocation and glide-path design that hews closely to the specific characteristics of their participant cohorts. These positive qualities have prompted the Department of Labor to suggest that plan sponsors consider customized TDFs for their QDIA option.[2]

As for market vulnerability, the word "customized" really means what it says. So, within the parameters of fiduciary duty of care, the plan sponsor can ensure that the TDF is truly diversified while still providing potential to capitalize on market opportunities. From an asset class perspective, this may mean the inclusion of developed market large-cap equities, as well as potential alpha-generating options such as small-caps and emerging markets equities; and in fixed income, including some exposure to high yield corporates and emerging markets debt with the aim of providing additional yield.

In terms of strategy choice, the sponsor can make informed decisions about where best to employ active versus passive vehicles in specific market segments. Within fixed income, for example, having active managers with the ability to limit exposure to low- or negative-yielding developed market indices and seek opportunistic exposure in more appealing areas may help with return generation. In equities, the use of a small-cap manager may help limit exposure to low quality and greater volatility often associated with more speculative companies found in major indices. The sponsor may also choose to include strategies such as put-writing, which have equity-like return profiles but lower volatility histories.

Sponsors in the Driver's Seat

Custom TDFs are not a panacea, of course. They do require more work on the part of the plan sponsor to ensure that all the elements of the plan meet regulatory requirements and serve the interests of participants. However, it would be a mistake to assume that they somehow heighten the sponsor's fiduciary responsibility. Even if a sponsor goes with an off-the-shelf fund, it is still required to make prudent inquiries into asset allocation, glide path and investment choices, not to mention the fees associated with its offerings. Meanwhile, a custom TDF will put the sponsor in the driver's seat by allowing it to fine-tune the plan investment options in a way that will likely not be possible in using a "one-size-fits-all" solution.

[2] "Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries," U.S. Department of Labor, Employee Benefits Security Administration, February 2013.

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