



*DCIIA Guide To U.S. Department Of Labor
Tips On Selecting Target Date Funds*



Public Policy Committee

INTRODUCTION

In February of 2013 the US Department of Labor (DOL) issued a fact sheet on target date retirement funds (TDFs) titled “Tips for ERISA Plan Fiduciaries.” The fact sheet can be accessed at <http://www.dol.gov/ebsa/newsroom/fsTDF.html>. Its objective is to provide guidance to plan fiduciaries as they select and monitor the TDFs in their defined contribution (DC) plan’s investment lineup. The following guide, prepared by the Defined Contribution Institutional Investment Association (DCIIA), is intended to supplement the DOL’s fact sheet and offer additional information on the different types of products that may be available.

DCIIA expects that plan fiduciaries will find the DOL’s fact sheet to be a useful tool. It is written in clear, non-technical language and includes steps that plan fiduciaries can easily understand. It also includes a section titled “Target Date Fund Basics,” which provides a helpful description of key characteristics of TDFs and can serve as an educational tool for both plan fiduciaries and plan participants.

From DCIIA’s perspective, a good starting point for plan fiduciaries when reviewing TDFs is to note that, while there are many variations among these funds, generally they all seek to offer:

- Diversification among asset classes,
- Professional fund asset management pre- and post-retirement, and
- Reduced exposure to equities as participants near retirement age.

These features, as well as the fiduciary protections available when one of these funds is offered as the plan’s qualified default investment alternative (QDIA), may make a TDF a prudent choice for both a plan fiduciary and plan participant. As an alternative to a TDF, some plan sponsors may choose another type of QDIA, such as a managed account or a balanced fund.

Each plan’s unique characteristics and circumstances will help inform an appropriate selection in which a wide range of product choices is available. Investment performance, level of diversification, cost and consistency with the plan’s objectives are key factors in choosing any default investment selection. Whatever the choice, both adhering to a selection process and documenting the decision are critical.

DEVELOPING A PRUDENT PROCESS

Although specific rules surrounding the selection and monitoring of TDFs are not included in the DOL’s fact sheet, the DOL stresses the importance of developing a prudent process and understanding the underlying components of TDFs. DCIIA likewise encourages plan fiduciaries to review the unique characteristics and circumstances of their plan and to consider the options that may be appropriate based on those considerations.

DCIIA also agrees that it is helpful for plan sponsors, together with their advisors, to understand the underlying investments and to review applicable prospectuses and/or offering materials. DCIIA believes that a “facts and circumstances” approach is appropriate, as the process of review may vary based on the plan’s specific characteristics such as plan size or participant demographics. It is also valuable to review the TDF for consistency with any investment policy statement or other plan document that defines how the plan’s investments should be selected and monitored.

CONSIDERATIONS FOR SELECTING TARGET DATE FUNDS

There are many options for plan fiduciaries to consider when deciding whether to incorporate a TDF into an investment lineup. In its fact sheet, the DOL emphasizes that considerable differences exist among TDFs; it points out the need for plan fiduciaries to understand the principal components of the various TDF strategies, as well as the primary differences among them, and to consider these

factors when determining which, if any, TDF would work best for their plan. Several of the central differences – glide path and portfolio construction, off-the-shelf vs. custom, type of investment vehicle underlying the strategy, and cost – are discussed below.

GLIDE PATH AND PORTFOLIO CONSTRUCTION CONSIDERATIONS

One of the primary differences among target date funds concerns the glide path, which is defined as the reduction of a fund’s equity exposure over time. A TDF’s glide path may be described as extending either “to” or “through” the targeted retirement date. A “to” glide path generally reduces the fund’s equity allocation to its most conservative level at the target retirement date, typically with flat or static allocations during the subsequent retirement years. A “through” glide path has an allocation to equities at the target retirement date that is typically, but not always, higher than “to” glide path managers’ allocations and continues to decline for 15 to 20 years after retirement. Exhibit 1 illustrates this difference.

SINGLE MANAGER OR MULTI MANAGER

In order to implement the glide path, a TDF typically includes allocations to a broad set of asset classes, e.g., fixed income, equities, non-US equities. Commonly, the allocation to a particular asset class is achieved by the TDF having an allocation to a standalone fund that invests solely in those assets; thus the TDF itself can be viewed as a collection of component funds.

For some TDFs, a single investment firm may manage all asset class component funds; in other cases, the TDF provider may employ different managers for each component fund. It is helpful to understand the structure of your TDF, as well as the provider’s fund selection, monitoring and replacement process.

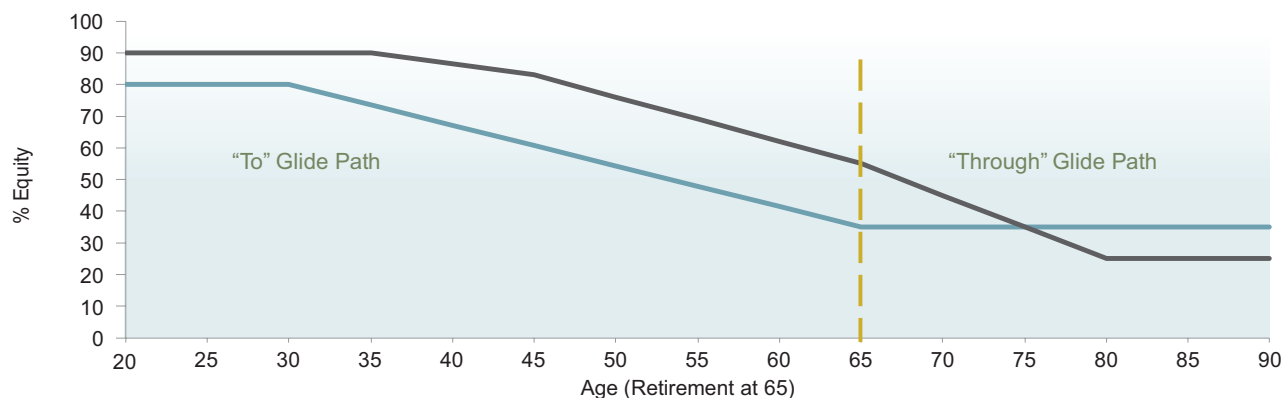
ASSET ALLOCATION

Regardless of whether a TDF provider uses a single investment manager or multiple managers, it is also helpful to understand which asset classes are included in the TDF and their investment objectives. The asset class components can be generally characterized as “growth” assets or “capital preservation” assets. Some TDFs include allocations to inflation-protection assets and/or alternatives. The TDF provider should be able to articulate the role of each asset class in the TDF.

PASSIVE OR ACTIVE, OR BOTH

A TDF’s asset class exposure may be implemented using only passively managed component funds, or only actively managed funds, or some combination of active and passive. Regardless of the approach adopted, knowing whether a component fund is expected to outperform its benchmark or match its benchmark is an important factor to consider in the periodic review of your plan’s TDF.

Exhibit 1 “To” Vs. “Through” – Easy To Visualize



OFF-THE-SHELF VS. CUSTOM TARGET DATE FUNDS

In its fact sheet, the DOL highlights the differences between what it terms “pre-packaged”, or “off-the-shelf”, TDFs and “custom” TDFs. Generally speaking, an off-the-shelf fund reflects a provider’s (or investment manager’s) pre-established investment offering, in which the fund’s investments, asset allocation, and glide path are set by the provider based on that provider’s broad assumptions regarding plan participants, plan demographics and other relevant considerations. Exhibit 2 highlights the central differences.

Off-the-shelf TDFs are often available on a commingled, or pooled, basis to various different types of tax-qualified DC plans, regardless of a plan’s size. Investment managers frequently offer them; record keepers and/or other regulated financial institutions also offer them, sometimes in conjunction with other plan services. Such funds may be managed by one investment firm, and provide little to no exposure to non-proprietary investment management. In other cases, they may include multi-manager strategies. Further, a TDF’s underlying investment management strategies can be active or passive, or both. Typically, an off-the-shelf TDF does not allow the plan fiduciary to make any modifications to the glide path, asset allocation, or underlying fund selection. It is important to note that, in this regard, the TDF market is evolving; there is,

for instance, an emerging alternative available for plan fiduciaries to select a model glide path and then populate it with a range of pre-selected underlying investment management options. Depending on the plan’s size, additional variations may also be available.

Custom TDFs are usually created for plan sponsors who desire more control over the construction of the fund than would normally be offered within a plan’s investment lineup. With such an offering, the plan fiduciary can influence the design of the glide path as well as the selection of both the underlying assets and the investment managers. A custom glide path may, for example, be designed to reflect specific plan demographics, such as average account balance, salary growth, contribution rates, withdrawal patterns, and whether or not the plan sponsor offers a traditional defined benefit plan. The underlying assets may include funds offered only within the plan’s core lineup, or they may include additional asset classes specific to that TDF. While custom TDFs can be created for any plan size, they are traditionally used in larger plans. Some plans seeking customization—especially smaller ones—may work with advisors to create model target date strategies based on the plan’s existing investment lineup. One of the factors to consider is cost—both the administrative and investment management fees. Large plans may find that a custom approach actually offers lower all-in costs than pre-packaged strategies.

Exhibit 2 Comparison of TDF Strategies

Features	Off-the-Shelf	Custom
Glide Path	Determined by TDF provider	Flexible
Investment Manager	Determined by TDF provider; may be same manager for all TDF components	Selected by plan sponsor/their advisor; typically multiple managers for TDF components
Asset Allocation	Determined by TDF provider	Determined by plan sponsor/their advisor; flexibility to add niche asset classes
Active and Passive Allocations	Determined by TDF provider	Determined by plan sponsor/their advisor
Fees	Typically embedded in the net asset value	Generally a la carte for custody, administration, investment management, etc.

INVESTMENT VEHICLES

Registered mutual funds are the most common types of off-the-shelf TDFs; they are often available to any plan, regardless of the asset level. Separate accounts and collective investment trusts are also an option, most commonly for larger plans. These separate accounts and collective investment trusts, along with institutional share classes of registered funds, may come with minimum asset level requirements. Plan fiduciaries should review the fund documents to confirm each TDF's specific eligibility requirements and other pertinent terms. From an oversight perspective, mutual funds and collective investment trusts must undergo annual (or more frequent) audits by a third party hired by the fund company or bank. Due diligence is conducted on each service provider (fund custodian, transfer agent, etc.). Investment guideline monitoring, adherence to valuation policies, and other critical tasks are monitored in scale by the fund companies offering collective and mutual funds. For custom TDFs that utilize separate accounts, additional fiduciary oversight may be required of the plan sponsor.

COST

Regardless of the type of target date strategy selected, plan fiduciaries should, as part of the selection process, consider cost. It helps to understand the overall expenses, such as investment management, custody, administration and marketing fees, and revenue sharing arrangements, and to evaluate them in the context of the value they provide. For example, value may be derived from net performance, asset diversification, flexibility of manager selection, risk management, and the linkage between glide path and participant outcomes. As noted above, there are many factors to consider when determining the TDF that best suits the plan's characteristics; total cost is one, but not the sole determinant. And, of course, documenting the process and all decisions is a prudent practice.

PLAN FIDUCIARIES ARE ENCOURAGED TO TAKE ADVANTAGE OF THE VARIETY OF EDUCATIONAL TOOLS AVAILABLE

The DOL's fact sheet urges plan fiduciaries to consult all available resources to assist in their TDF decision making and review process. There are many commercially available sources of information, as well as additional resources listed on the DOL's website at <http://www.dol.gov/ebsa>. DCIIA also has written other papers to assist plan fiduciaries in their selection of TDFs, including:

“The “To vs. Through” Target Date Debate: Is there a Better Way to Frame the Glide Path Discussion?”

“Considerations for Implementing a Custom Target Date Approach: A Guide for Defined Contribution Plan Sponsors”

DCIIA continues to develop additional guidance on this topic for plan fiduciaries. Please visit our website for more information.

SUMMARY

In its fact sheet, “Tips for ERISA Plan Fiduciaries,” the DOL stresses the importance of developing a prudent process, understanding the underlying components that make up a plan's TDF strategy, and documenting one's selection and review process. While the DOL's fact sheet does not outline specific rules for selecting a TDF, the general guidance it provides, combined with this DCIIA guide, should be a useful resource for plan fiduciaries involved in the TDF selection and review process.

ABOUT DCIIA:

The Defined Contribution Institutional Investment Association (DCIIA) is a non-profit association dedicated to enhancing the retirement security of American workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants. For more information, visit www.dciia.org.