

Look Before You Invest

What every plan sponsor should know about Target Retirement Funds.

By Trisha Brambley

This is the first article of a three-part series about Target Retirement Funds.

Thinking about offering Target Retirement Funds? Or did you recently begin to offer them to your participants? This primer will help you understand what you need to know.

1. "Target date retirement funds" (TDRF) are not the same as lifestyle funds.

They are both a pre-packaged basket of funds that automatically rebalance in accordance with a pre-determined allocation percentage among cash, stocks, and bonds. The lifestyle funds are "risk-tolerance centered," and the target retirement funds are "time-horizon centered." In other words, if your plan offers lifestyle funds, the participants decide if they are a moderate, conservative, or aggressive investor, and the fund is weighted with more or less stock in accordance with the selected risk tolerance. A 25-year-old participant and a 60-year-old participant who describe themselves as aggressive investors have the same percentage allocated to stock.

A target retirement fund, on the other hand, asks participants to select the date at which they hope to retire, and a 25-year-old will have more exposure to stock than a 60-year-old, due to the ability to absorb volatility risk better over a longer time period than a short

one. However, under this approach, 60-year-old with a huge nest egg would have the same allocation model as a 60-year-old with no other savings.

Though both methods are imperfect, plan sponsors and their advisors are embracing the target model, because to have an allocation model that automatically adjusts over time is just plain smarter than what many participants do, which is pick a few funds at random and never change again.

2. There is no right answer as to how to allocate funds based on age.

You may think that there is some key asset allocation model for each age category. Alas, there is not. Although most financial advisors will recommend that the percentage of stock you own should decrease over time as you near retirement, there isn't any right answer as to what that percentage should be and when. In fact, some financial advisors are suggesting more weighting in stock than they used to, because people live longer. Now, many providers are offering significantly more in stock within each age band of their targeted funds.

Yes, asset allocation is an art, not a science. As a plan sponsor, you need to understand the model your investment provider uses, and be sure you agree that it is prudent.

3. Longevity influences the big sellers of TDRF.

Longevity is risky. In other words, outliving your money is one of the biggest financial risks an investor takes. The target date funds are often designed for post-retirement too, as a way to automatically invest rollover monies.

4. They address the needs of the uninterested.

Every plan sponsor I have ever worked with has asked, "What can be done to help the participants who won't read anything, attend any of the meetings, or use the online tools?" There is a significant percentage of the population who are simply frozen into inaction because they don't understand investments and, frankly, don't want to learn. Finally, the retirement plan industry is coming up with better and better ways to face this reality and to help people invest intelligently. The target date funds are an attempt to deliver a "Buy and Forget It" option. Not only does the participant get a broad array of stocks, bonds, and cash, but their investments are automatically invested more conservatively as the retirement date approaches. Almost no participant does this kind of re-balancing on their own initiative; in fact, only about 3 percent of participants ever rebalance.

5. They also address the needs of the knowledgeable.

Participants who are interested in investments readily understand the advantages of target date funds. Some participants have even told us that they are going to modify their target date fund by investing in the stable value fund or international fund, so they can customize the approach in a simple way.



6. As a fiduciary, you need to monitor them.

And therein lies the rub. You will need to monitor these funds just as carefully as any other fund in your plan's offerings, and that presents a few challenges. Do you only want funds with a minimum of a three-year track record? Your list will be quite short. Should you change your investment policy to permit these funds if each "slice" of the allocation pie is at least three years old, even if the particular fund-of-funds is not? Will you monitor the funds by creating a custom benchmark to mirror the allocation of the funds? Will you drill deeper and monitor the "slices" of each

allocation pie? And what will you do if any of the funds — indeed any slice of the fund — fails to meet your standards? Some vendors custom-create the target funds based on the funds in your core line-up, even if they aren't proprietary funds. This approach makes it easy to select and deselect funds within the target fund with the same ease and security as other fund options, as long as the recordkeeping platform can accommodate it.

7. New on the landscape.

Because of the popularity of these funds, new approaches are coming forward. In some situations, for example, participants are permitted to tailor their fund by designating whether they are a conservative, moderate, or aggressive investor. Another trend is to have the age bands reduced from ten-year increments to five. Finally, some advisors will tailor a model for you, based on your requirements and policy, and in accordance with the core options of your plan. This would be the most

customized way to approach these funds and could support a prudent investment strategy, but your vendor or administrator has to be able to support it. You will need to ask.

8. How much do they cost?

Depending on the provider of the investment models, there may be two layers of fees to note. One is the expense ratio of each of the underlying funds. Is each one reasonable? Another is the fee for packaging the funds together. We've seen this fee range from zero to 200 basis points (that is 2 percent!). Buyer beware.

9. Some plans use it as the default option.

Some plan investment committees have raised concerns about how many participants put their money in a money market. Many committees are concerned that they have used the money market or stable value fund as the default option, and it became the largest fund in their line-up. As a prudent person, knowledgeable about investments, the committee members wonder if a target retirement fund would be the better vehicle for default investment elections. We see more and more plan committees taking this action.

10. The DB-ing of 401(k) plans.

As defined benefit plans wane, plan sponsors are faced with the ethical challenge of handing over investment decisions to a largely financially unskilled participant base. A well-understood, well-priced, and good-performing targeted fund can help participants by continuing a form of the automatically-invested-for you concept of a defined benefit plan.

Looking Ahead

In the next couple of issues of PSCA's *Defined Contribution Insights* magazine, stay tuned for more in-depth articles on some of the important concepts we have raised here. Target Retirement Funds cannot be implemented without care. When studied, monitored, benchmarked, and communicated well, these funds can be a big help to your participants. They deserve a deeper look. ➤

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