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Magazine

PLANSPONSOR 2009 Ultimate Buyer's Guide: Target Date:Target Practices

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Maybe we were solving for the wrong equation. When investment managers introduced the first target-date funds in the early 1990s, their primary goal was to help people accumulate assets in a way that automatically would account for the need to invest more conservatively as their investment horizon shortened. Accordingly, target-date funds were set up to gradually reduce their equity exposure as investors aged. Nothing much changed over the ensuing decade and a half.

Illustration By Olaf Hajek

Now, it may have to. Stunned by the financial market meltdown of the past 18 months and the losses sustained by retirement plan investors—in late February, one popular 2010 target-date fund was down 41% from its October 2007 high—some plan sponsors appear to be shrinking away from them.

"We've seen, very recently, that sponsors are a little more reluctant to choose lifecycle or other asset allocation solutions as their qualified default investment alternative," says Tina Wilson, Vice President of Product Development for MassMutual Retirement Services. "They have opted to offer a stable-value fund instead. In effect, they're giving up the QDIA protection because they are concerned about their participants losing money."

To make sure that does not become a trend, plan providers and investment managers alike now are focusing not only on how much retirement plan participants can accumulate in target-date funds—still the retirement plan industry's most popular QDIA—but also on how much income they can generate from those funds once they stop working, regardless of market conditions at that time.

"Collectively, as an industry, we didn’t focus enough on potential outcomes," says Drew Carrington, Managing Director of UBS Global Asset Management and Head of its Defined Contribution and Retirement Solutions Group. While arguing against any dramatic overhaul of

the target-date model, he says his firm is among those seeking to make the funds work better for people closest to retirement.

Last year, UBS partnered with Genworth Life and Annuity Insurance Company to make a guaranteed lifetime withdrawal benefit available to investors in its target-date funds. It works by allowing investors to shift money out of their target-date funds as they get close to retirement, perhaps around age 55, and into a global balanced fund protected by an insurance wrapper. At age 65, they are eligible to receive guaranteed lifetime withdrawals from the balanced fund equal to the greater of 5% of all contributions and transfers, or 5% of their highest account balance on any birthday.

Many other investment managers are exploring, and in some cases have already begun to offer, target-date funds with similar income guarantees. Barclays Global Investors, for example, last year selected MetLife to supply an annuity product for inclusion in its target-date funds. It is a trend that Wilson expects will continue. “It will give retirement plan investors a growing income component not subject to market volatility, while at the same time offering them exposure to equities to fund growth and mitigate longevity risk,” she says. She also predicts plan sponsors will embrace target-date funds that allocate some of their assets to stable-value funds as a way to hedge against market downturns, as some of the country’s larger plan sponsors have done already.

Standing Pat

Adding income guarantees or stable-value products to target-date funds does not jeopardize their status as a QDIA. Still, Kathleen Whalen, Managing Director of research and consulting firm Dalbar Inc., predicts the Obama administration eventually will accord formal QDIA protection to such funds anyway, which almost certainly will boost their popularity.

Despite calls from some critics to pare back equity allocations in the wake of the stock market's free fall over the past 18 months, most investment managers thus far seem committed to their current allocation strategies.

The problem with making any material change now, observes Lori Lucas, Defined Contribution Practice Leader for consulting firm Callan Associates, is that it would look a lot like market timing—anathema to most target-date managers and many plan sponsors. On the other hand, she says, fund managers do appear to be making some modest changes to the bond portfolios in their target-date funds by adding new or greater allocations to Treasury Inflation-Protected Securities, or TIPS. The goal is both to further diversify their portfolios and to hedge against any uptick in inflation once the economy begins to recover.

Given the market turmoil of the past 18 months, Lucas says, this is a good time for plan sponsors to reassess their use of target-date funds as the default investment option in their defined contribution plans. Of particular concern, she says, is that 43% of plan sponsors who offer target-date funds use the ones managed by their recordkeeper rather than a third-party provider. "That's an unfortunate finding," she says, "because it suggests that those sponsors may be viewing target-date funds too much as a commodity, and really are not sitting down and figuring out to what extent the glide path or asset allocation mix of their funds really suits their plan demographics." Those metrics can vary greatly from fund family to fund family, she says, noting, by way of example, that there is as much as a 30% to 40% variation in the equity component of 2020 funds currently on the market.

Given that sort of variation, it indeed may be time for plan sponsors to cast a more judicious eye on their target-date fund offerings. The extraordinary economic events of the past year and half may not warrant changing them, but they certainly merit a fresh look at how those funds are performing.

Risk-Based Funds

Since the U.S. Department of Labor spelled out in 2007 what constitutes a qualified default investment alternative (QDIA) for defined contribution plan participants, risk-based or balanced funds have played second fiddle to target-date funds. At Vanguard Group, for example, 80% of sponsors who have selected a QDIA have chosen target-date funds. That bias may not change dramatically in the wake of the financial market meltdown, but some retirement experts believe that risk-based funds will emerge as a more popular default investment option over the next few years.

"The economic crisis has highlighted the need to manage risk more effectively," says Kathleen Whalen, Managing Director of Dalbar Inc., a research and consulting firm serving the financial services industry. "Protection from large losses will be at a premium and will make target-risk funds far more popular."

The logic behind this argument revolves largely around the recent performance of target-date funds aimed at younger investors. While many retirement plan critics have blasted the losses booked recently by target-date funds aimed at investors in or near retirement, others have worried that the even bigger losses sustained by target-date funds aimed at young investors are problematic, too, because they could sour those investors on the whole idea of saving for retirement. From October 2007 through late February 2009, for example, some popular 2050 target-date funds lost more than half their value.

Steve Utkus, Head of the Vanguard Center for Retirement Research at fund complex Vanguard Group, says it will be interesting to see whether more sponsors choose balanced funds over target-date funds as their default investment option. Both are QDIAs under U.S. Department of Labor guidelines, as are managed accounts. "We're not seeing that right now," he concedes, "but there is a possibility some sponsors will just want a simple, lower-risk portfolio, like a 50-50 balanced fund, for everybody, rather than target-date funds that have riskier portfolios for younger people." He also predicts that plan sponsors that have yet to choose a QDIA plan may make more conservative choices than those that made that choice three or four years ago.

Prudent Steps

For plan sponsors that have been using target-date funds as a default investment option, Whalen argues that the prudent man rule that informs their fiduciary responsibilities obliges them to at least consider whether they still make sense for their plan participants. "It is a legitimate argument that no one could have anticipated the economic crisis," she says, "but now that it has occurred, the argument cannot be made again. Plan sponsors must demonstrate that they have taken prudent steps to prevent further losses."

One possible solution, Whalen says, would be to replace target-date funds with a range of risk-based options; many investment managers offer target-risk funds in a series ranging from conservative to aggressive. Participants would merely need to indicate their risk preference to be defaulted into the appropriate fund in such a series. The problem, of course, is that some workers fail to make any choices at all regarding their retirement plan participation, which would throw the onus for making a decision back on the plan sponsor.

An alternative approach offered by some investment managers, including UBS Global Asset Management and MassMutual Retirement Services, is to use a series of target-date funds that come in differing risk profiles, again ranging from conservative to aggressive, as their default investment option. "The way we see plan sponsors using these," says Tina Wilson, MassMutual's Vice President of Product Development, "is that they would pick the entire target-maturity series and then default participants into the moderate portfolio of the one that matches their retirement horizon." Later, she says, participants could decide if they want to stay in the moderate portfolio or switch to the conservative or aggressive portfolio.

Reassessing a plan's choice of a default investment option is hardly a bad idea but, Utkus cautions, sponsors should be wary of making any rash decisions. “When you look at what happened in 2008, you see that we had catastrophic financial system problems around subprime mortgages,” he says. “The kinds of assets underlying 401(k) plans and target-date funds weren’t at the core of the problem, they were just affected by the problem. I don’t think too many people will say that we should create portfolios solely to insulate ourselves against another subprime crisis.”

Managed Accounts

These may be just the times for managed accounts. One of three types of long-term qualified default investment alternatives (QDIAs) available to defined contribution plans, managed accounts have been slow to attract interest. In the 2008 PLANSPONSOR Defined Contribution Survey, only 5% of plans that had chosen QDIAs were using managed accounts as their default investment option. The rest opted for risk-based funds or, more frequently, target-date funds, but the economic turmoil that scorched virtually all popular investment options over the past year and a half may prompt some plan sponsors to reconsider that decision.

"Most retirement plan investors have lost a lot of money, and basically need much more help than they did before," says Ken Fine, Head of Marketing for investment advice provider Financial Engines Inc., which offers managed account services for a number of plan providers. "I think the marketplace is going to be demanding solutions that go beyond helping investors with their asset allocation decisions, and managed accounts, at least as we offer them, can do that. They're really about creating a retirement plan that works and getting people to a successful retirement."

Plan sponsors already have warmed some toward managed accounts; in the PLANSPONSOR survey, for example, the 5% of plans offering them last year was up from 4.3% in 2007. However, virtually all of that market-share gain came from sponsors who were getting rid of stable value or money market funds as their default investment, and it paled in comparison to the 74.7% increase in the number of sponsors using risk-based lifecycle funds and the 33% jump in those using target-date funds.

Steve Utkus, Head of the Vanguard Center for Retirement Research at fund company Vanguard Group, confirms that, as for most recordkeepers, relatively few plan sponsors use its managed account program, for which Financial Engines is the subadviser. However, he speculates that demand may start to increase among plan sponsors whose employees are relatively aggressive investors, especially if target-date and target-risk funds start to pare their equity exposure in response to the market's recent collapse.

To be sure, managed accounts are not inherently better than target-risk or target-date funds, nor more immune to losses. Poor investment advisers can lose money just as fast, if not faster, but managed accounts offer a level of customization that is difficult to replicate in any other format. “If you have someone with restricted company stock or a cash balance plan or nonqualified plan, the managed account framework allows us to personalize the target asset allocation mix to the needs of that individual,” observes Christopher Jones, Executive Vice President of Investment Management and Chief Investment Officer for Financial Engines. “That’s not true for a target-date or target-risk fund.” Participants using a managed account service also typically have the option of speaking with an adviser who can help them make other important decisions, such as how much to save and how long they may need to work to meet their retirement goals.

Retirement Income Needs

Because managed account providers typically work with the investment options available in

the plan where their services are offered—and those menus vary from plan to plan—it can be difficult to track down broad-based performance metrics for them.

However, performance results for non-401(k) clients published by PMFM Inc., which offers managed accounts services under its 401k Toolbox brand, suggest that the strategy holds some promise. On its Web site, PMFM shows that its conservative "Managed Strategy," which has the flexibility to invest 100% of its assets in money market funds, lost just 4.7% in 2008. Meanwhile, its more aggressive "Advantage Strategy," which always maintains a core allocation of approximately 50% to equities, but can go higher than that, lost 22.6%. By comparison, losses for three of the most popular 2025 target-date funds managed by Vanguard, Fidelity, and T. Rowe Price last year ranged from -30.1% (Vanguard) to -35.9% (T. Rowe Price).

Of course, plan sponsors searching for a managed account provider today may want to look for one that can address not just the asset accumulation needs of their plan participants, but also their retirement income needs—an increasingly bigger issue in the defined contribution marketplace.

At Financial Engines, Fine says, “We have teams working on drawdown services that could work both within a 401(k) plan or in a rollover account by moving assets from a growth orientation to a preservation and drawdown orientation, and that can begin to protect the portfolio.” While this service has not been deployed yet, he says, it eventually could include some type of insurance products to protect investor assets in or near retirement. However, he added, “We've seen some skittishness among plan sponsors about putting products with guarantees into their plans, as the solvency of insurance companies has been tested over the past year.”

Plan sponsors also will want to pay attention to the cost of managed accounts. They have long been criticized for being more expensive than target-date or target-risk funds and, depending upon the provider, that certainly can be true—though Financial Engines contends it typically can deliver managed accounts at an all-in cost of 60 to 65 basis points. That figure can be higher, or dramatically lower, depending upon the size of the plan and the expenses charged for its underlying investments and, while those costs are more than those for a passively managed target-date or target-risk fund, they are hardly out of line with actively managed funds.

SURVIVAL TIPS

Know your glide path—all target-date funds are not the same.

Know how much you are paying for what you are getting.

Pick the best fund suite for your plan—then push your recordkeeper to add it to its platform.

Still, it is a matter that plan sponsors will want to take into consideration. “If anything, in the current market, costs are more important than ever,” observes Lori Lucas, Defined Contribution Practice Leader for consulting firm Callan Associates.

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