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SITE CONTENTS
Home Page
Research Center
Community Center
Vendor Directory
Conferences, Commentary & More
The Hot List

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Compensation, Benefits & Rewards
HR Management
Legal Insight
Recruiting & Staffing
Software & Technology
Training & Development

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Workforce Recruiting
Workforce Benefits
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Update Profile
Log Out
Help
Site Guide

Comp, Benefits, Rewards: What's New

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Target-Date Funds: Handle With Care

Creating customized target-date portfolios might give plan sponsors a cheaper and more flexible default option than target-date mutual funds.

By Lori Lucas

Fast forward to 2017: What will the typical defined-contribution plan look like?

By many estimates, the defined-contribution plan of the future will have very high participation due to the prevalence of automatic enrollment. And, through a combination of well-documented 401(k) participant behavioral tendencies such as inertia and procrastination, the majority of assets will reside in the plan's default investment vehicle.

That default vehicle is most likely to be a set of target-date funds.

In Callan Associates' recently published Qualified Default Investment Alternative Survey, more than 70 percent of plan sponsors responded that they intend to use target-date funds as their qualified default investment alternative in accordance with draft Department of Labor guidelines. As a result, decisions about how to structure target-date funds could have a profound impact on their plan participants' long-term investment outcomes.

With dozens of target-date funds coming to market, choosing the right one for a defined-contribution plan is not easy. Target-date asset allocations (also known as glide paths or roll-down paths) vary widely. The number of underlying funds can range from a handful to dozens. And, of course, the range of fees is wide, from 0.20 percent for target-date index funds to well over 1 percent for actively managed target date mutual funds.

For large plan sponsors, those with $1 billion in their plans and 15,000 to 20,000 employees, one approach to consider is creating custom target-date funds based on their core investment fund lineup. This approach allows plan sponsors to tailor the target-date glide path to the demographics and needs of their 401(k) participants. It can enable them to leverage the due diligence efforts of their core investment options and achieve a "best of breed" fund lineup in their target-date portfolios.

If an underlying fund within the target-date structure is underperforming, the custom target-date approach better facilitates tracking its performance—providing the plan sponsor with the flexibility to replace the underlying fund as needed.

Notably, the potentially positive impact on fees of the custom target-date approach should not be underestimated. According to the Callan Defined Contribution Index, target-date funds today account for about 9 percent of assets across large defined-contribution plans.

What if a few years from now target-date funds account for the majority of plan assets? In this situation, a plan that uses low-cost separate accounts and collective trusts for its core investment funds—but target-date mutual funds for its default—may find that the weighted average plan cost has increased.

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Further, this shift of monies away from the core investment options into the target-date mutual funds can also affect the pricing power of the core investment funds, reducing their economies of scale.

Consider, for example, a plan with a series of low-cost institutional mutual funds, collective trusts and separate accounts with an aggregate weighted average total plan cost of 45 basis points. Say that the plan decided to add typical, reasonably priced target-date mutual funds with fees ranging from 61 to 81 basis points (depending on the target-date fund). If 50 percent of monies within the plan eventually moved to the target-date mutual funds, the weighted total plan cost in this case might increase to more than 60 basis points—a 33 percent increase in total expenses for plan participants.

We compared the cost of custom target-date funds based on low-cost separate accounts and collective trusts within one large plan relative to the cost of a series of typical, reasonably priced target-date mutual funds. Depending upon the target-date fund in question, costs were 10 percent to 23 percent lower for the custom target-date approach.

Many plan sponsors that are considering the custom target-date approach view their target-date funds as mini pension plans. As such, they seek to replicate the asset allocations more typical of defined-benefit than defined-contribution plans. While a plan sponsor may hesitate to offer Treasury inflation-protected securities (TIPS) and commodities as core investment options, these same vehicles may be very attractive diversifiers within custom target-date funds.

Emerging-market funds are generally considered unattractive core investment options by many plan sponsors because they are often used by 401(k) participants to chase short-term performance. Plan sponsors can use these funds within the custom target-date approach only, allowing the target-date funds to reap the diversification benefits without running afoul of counterproductive participation behaviors.

Similarly, the lack of liquidity of direct real estate investment is an impediment to the inclusion of real estate in the core investment fund lineup. Within target-date funds, however, the liquidity issue can be more easily managed.

Of course, the custom target-date fund approach is not for every 401(k) plan. It is likely impractical for smaller plans. Further, plan sponsors may not be able to dedicate the required time and resources to properly implement and monitor the approach.

Likewise, even plan sponsors committed to this strategy may face hurdles: Some record keepers and custodians may not have the systems in place to easily accommodate the custom target-date approach. Providers may also impose setup costs that may be prohibitive.

However, even if the custom approach isn't right for a given plan sponsor, there are other increasingly flexible alternatives available. These include collective trust approaches that are based on best-in-class managers. Collective trusts can often have the added appeal of low cost structure. Modular collective trust approaches to target-date funds are also coming to market. These allow plan sponsors to pick and choose combinations of actively and passively managed collective trusts, and even tailor the glide path to plan demographics.

Plan sponsors who select the mutual fund route today will wish to watch closely as the target-date fund segment develops, with an eye to evolving their target-date fund solution. At the same time, it is important to recognize that—as with any investment in the 401(k) plan—once the target-date fund investments are put into place, it will not necessarily be easy to unwind them.

With this in mind, plan sponsors are wise to consider not only the 401(k) plan that they manage today in selecting target-date funds, but their 401(k) plan of the future.

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