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Target-Date Funds: The Investment Manager's Venus Fly Trap

What plan sponsors need to know about target-date funds and conflicts of interest

Summary:

- Target-date funds are the Holy Grail for mutual fund investment companies: greater share of the assets, more control of the assets, little or no competition (in the target-date category in the plan line-up) and a hard-to-benchmark product.
- Not all target-date funds are created equal and asset allocations are not standardized. While the target-date may be the same, asset and risk allocations can differ significantly between funds.
- There is a better solution: Risk-based allocations that provide greater transparency, easier benchmarking, an open architecture platform, and easy-to-understand risk allocations.

Target-date funds have become the preferred investment for many 401(k) participants seeking professional guidance on their retirement savings. In just two decades, target-date funds have grown to over $700 billion as of the end of 2014[1]. A Cerulli Associates Inc. study predicts that by year 2018, target-date funds will attract 63.4% of 401(k) contributions, and will constitute 35% of total 401(k) assets[2].

While we appreciate the simplicity that target-date funds provide to novice or less informed investors with its glide-path investment management, we do not believe that target-date funds are the panacea for participants and plan sponsors. In fact, as we will outline in this report, the largest beneficiary of target-date funds are mutual fund management companies, and often this is at the expense of plan sponsors and participants.

Target-date funds' biggest benefit could be its most fatal flaw: asset allocation decisions are decided by the investment manager and not by plan participants. In some sense, the scenario is like the fox guarding the hen house. This is exactly why insurance and mutual fund company platforms are not fiduciaries on their clients' plans. <u>There is an inherent conflict of interest that these companies will do what is in their best interest.</u>

Panacea for Investment Managers

Target-date selection is the most desired allocation in the 401(k) lineup by fund management companies for the following reasons:

1) Investment managers get 100% of the asset allocation. Instead of having to compete separately for each asset class allocation (i.e. large cap, core fixed income), investment managers are now able to get 100% of the participant's assets with a target-date fund selection.
2) Target-date funds tend to be less scrutinized than individual asset funds as investors are not as focused on performance but matching their retirement year target.
3) Many plan sponsors decide to use target-date funds as their plan's designated default qualified investment alternative ("QDIA") under Department of Labor ("DOL") regulations. A QDIA is a default qualified investment option chosen by a plan fiduciary for participants who fail to make an investment election regarding their retirement assets. This feature is even more valuable as plan sponsors are not opting to have automatic enrollment for eligible participants.
4) Despite the importance of a target-date fund, rarely do we see any competing target-date fund products in a plan's investment lineup. We have reviewed numerous 401(k) plan investment options and there are little to no competing target date or risk based options. It is an all or nothing allocation. It is surprising that plan sponsors will put 4-5 large cap manager options, because they don't want to be responsible for choosing one large cap active manager, yet they will automatically defer to one fund family to manage an entire pool of assets. The reality, as we will see below, is that the dispersion among active target-date managers has the potential to be much greater than a narrowly defined universe like US large caps.

In a nutshell, investment managers are getting 100% of a participant's money by promoting target-date funds while having no competing products.

Hard to Monitor for Plan Sponsors

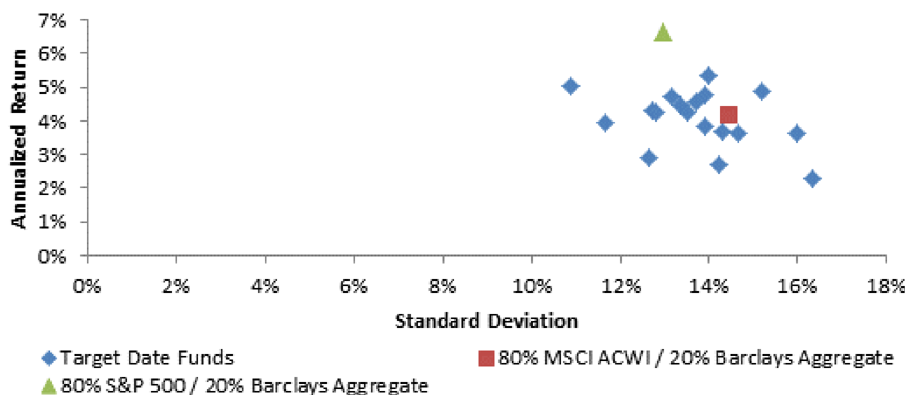
Single asset class funds like US large cap are not only easy to benchmark using index benchmarks, but the comparison relative to their peers is quite easy given the narrowly defined investment base. To the extent investment management firms can avoid difficult to beat benchmarks and defined investment universes, the better for them. Target-date funds are ideal for money managers as it is difficult for non-investment professionals to monitor for the following reasons:

1) **Target-date funds are hard to benchmark using passive indexes**. For example, how exactly would you benchmark a 2025 target-date fund? The difficulty with designing a viable passive index benchmark is that target-date funds have three main components that will need to be addressed:
   a. What are the equity and fixed income indexes to be used?
   b. What is the equity to fixed income mix for each target-date?
   c. What is the methodology to deallocate from equities as time elapses?

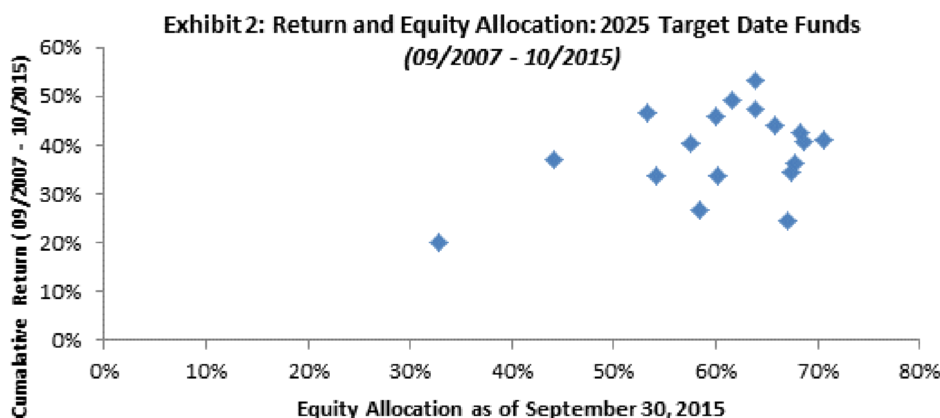
   These components make benchmarking very difficult even for seasoned investment professionals. In addition, a completely passive target-date fund does not exist. An active decision must be made on the asset allocation and deallocation method.

2) **Not all target-date funds are created equal**. Target-date funds within different investment fund groups can be quite different and in some cases the only common attribute is target-date. More times than not, the underlying risk allocations among different target-date funds with the same target year are quite different. This difference in risk return profiles makes benchmarking difficult, as return is also a component of the amount of risk taken. Using Zephyr StyleAdvisor and the Morningstar database, we analyzed all 2025 target-date funds that had an inception date before January 2007. Our objective was we wanted to compare different 2025 target-date funds in a full market cycle. Within the target-date funds that matched our criteria, we selected either the institutional class or the lowest fee class from each fund family. As such, we were left with 18 target-date funds(3). Our findings are as follows (performance is from 2007 – October 2015):
   a. **Huge performance dispersion in returns**. As Exhibit 1 illustrates, the dispersion in the total compounded return between the best performing fund, which returned 53%, and the worst fund, which returned a paltry 20.09%, was very large and concerning(4). Considering that target-date funds are most likely 100% of a participant's 401k holdings, those participants that were put in the worst performing fund are at a significant disadvantage in their retirement prospects than even the average 2025 target-date fund (38%) especially, when taking into account this age group is close to the end of their retirement accumulation phase.
   b. **Big difference in asset allocation**. As of September 2015, the risk allocations between the managers were quite different. While the average equity allocation was 60%, there was one manager that had only a 33% allocation in contrast to another that had a 70% allocation (5). It is quite astounding that within the same retirement age target, you have anywhere between a conservative allocation to possibly an aggressive allocation as determined by Morningstar's risk based categories. These different risk allocations make it hard to benchmark and create much different risk profiles. It also creates confusion for participants. Keep in mind that this is for a fund that has a target-date of only 10 years from today!

Exhibit 1: Risk Return Chart of 2025 Target Date Funds
(09/2007 - 10/2015)



Source: Zephyr StyleAdvisor, Morningstar Inc., Commerce Street Peak Advisors



Source: Zephyr StyleAdvisor, Morningstar Inc., Commerce Street Peak Advisors

3) **Closed platforms as investment management companies keep the assets all in house**. Out of the 18 mutual funds that we analyzed, only 4 fund groups chose to have an open architecture platform, meaning that they choose investments outside their own fund family. Are we to believe that a third party investor would allocate the same way? Highly unlikely as we have yet to see an institution or an investment consultant allocate 100% of the money to one fund family unless the assets were 100% indexed. This is a big benefit to the investment managers as research has shown that investment managers favor their own funds and are slow to fire themselves [(6)]. Not only are investment managers not firing a particular poor performing underlying fund that is within the target-date fund, they are actually giving the poor performing fund more dollars as assets flow into the allocating target-date fund each pay period, which trickles down to the poor performing fund. In addition, as the investment manager has sole discretion over the asset allocation, they can use its target-date pool to launch a new fund group. How convenient, since there probably aren't many plan sponsors that would include a fund with no history on its 401(k) platform.
4) **Difficult to switch target-date funds if on an insurance or mutual fund platform**. Many 401(k) plan sponsors that utilize mutual fund or insurance company platforms will find it difficult to replace the platform's target-date fund lineup. Often these platforms have a minimum level of assets that must be in their fund family to remain on the platform. Considering that a majority of 401(k) assets are going to target-date funds, plan sponsors

might have to find a new platform, record-keeper should they fire, and switch a platform's target-date fund selection. This makes these assets stickier and creates a barrier for the plan sponsor to act solely in their participant's best interest.

5) **Difficult to monitor the underlying allocations**. On the DOL's website, one of the plan sponsor's obligations is to "Understand the fund's investments – the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time." It is our view that this means that plan sponsors must understand what underlying funds are in a target-date fund. We think this will increasingly be more important as Morningstar has stated that alternative investments are now more common in target-date funds(1). Alternatives may add benefits but they also add to the expense and investment complexity.

Psychology of Investing and Participant Investment Behavior Issues

Target-date funds are designed to make investing easier for participants, especially for inexperienced investors or those who don't have the time to make informed decisions. However, we have seen a disconnect between investing theory and execution. Often when mapping over new client investments, we have seen participants that allocate to a target-date fund as well as another mutual fund. Anytime a target-date fund is allocated with another mutual fund whether it is an equity or fixed income fund, it completely changes the glide path and the purpose of the target-date fund. Perhaps the addition of the other fund was done on purpose, but it will require a complete deconstruction of the target-date fund's asset allocation to make an informed decision.

Another issue we see with target funds is that participants can be swayed easily from performance, whether warranted or not. A participant might not understand the risk in the target fund and, as such, be prone to switch during a drawdown. This type of investor can see the target-date fund as a singular investment rather than an investment portfolio. As such, a drawdown can be seen as a fund manager error rather than appropriate risk in a bear market. As easy as it is to allocate a target-date fund, it is just as easy to sell it, whether right or wrong.

Our last issue is more a pet peeve of ours. Investing in a target-date fund doesn't assure a safe retirement. The practicality of target-date funds depends on the savings and contribution rate of each participant. Not all participants that are expected to retire at the same time have the same risk / return profile. We do not think that a participant with a 3% contribution that just started investing and a participant with a 10% contribution with a long period of investing should be in the same target-date fund. At some point, one of those participants is going to want or even need to increase or decrease their risk.

A Better Way

Instead of a target fund approach we prefer risk-based portfolios for simplicity, for both the plan sponsor and plan participant.

- **Risk allocation is easily understood**. Participants can be defaulted to a risk-based model just like a target fund based on their age. The risk model can also change as participants hit certain age thresholds. Risk models are also easier for participants to personalize based on their risk tolerance or return needs. For example, a 48 year-old participant will be defaulted to our moderate aggressive model. This participant knows intuitively that she is risk adverse and can move down in risk to the moderate risk model. While this investor might not be taking as much risk as needed, she is still taking risk and has a better understanding of her investment. Conversely, if a participant is 55 years old and knows that he hasn't saved enough, he knows that he might have to move up in

risk (and hopefully increase his savings rate!) to be better prepared for retirement. He also realizes that by doing so, he will be subject to more return volatility.

- **Our risk model portfolios are on an open architecture platform.** We choose fund investments based on merits not affiliations. In essence, we have more tools from which to choose and are conflict-free. While we prefer keeping costs as low as possible and as such prefer passive investments, for certain asset classes, we choose active funds when it is a better fit.
- **Risk based portfolios are easy to benchmark.** Risk-based portfolios are both peer and index risk-based benchmarks. Plan sponsors can easily determine relative performance and follow the investment policy on evaluating and monitoring the risk based portfolios.
- **Full Transparency.** Participants see their investment diversification in models versus a single fund allocation. We believe there is a psychological edge when a participant sees their diversified holding versus a single investment for their entire 401(k) holding (and possibly entire retirement savings).
- **If on an open architecture platform, it is easy to fire us or any advisor**. If you don't like our models or believe that our solution is not in the best interest of participants, then you can replace us without fear you will have to change custodians or record-keepers. Open architecture platforms make firing advisors easy.
- **Low cost because fees matter**. Done properly, risk based models should lower the plan participants cost and as such, give the models in edge over higher fee target-date solutions.

Summary

Contrary to popular sentiment, target-date funds are by no means a check-the-box and move on investment option. Target-date funds can add more complexity and monitoring risks for a plan sponsor. A plan sponsor's monitoring obligations don't change and in fact might increase depending on the return/risk profile of a target-date fund, and the inclusion of alternative investments in a target-date fund's asset allocation. Plan sponsors need to ask and understand the following questions: why they chose a certain target-date investment manager, why they are giving the investment manager exclusive rights for the target-date allocation, and last and most importantly, is their current provider and solution in their participants' best interest or in the investment manager's? One question that should not be asked is "How hard will it be to change"? If decisions are based on short term difficulty, then the provider just fell into the manager's **Venus Fly Trap**.

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1) Morningstar,Inc. 2015 Target-Date Fund Landscape Report, http://corporate.morningstar.com/US/asp/subject.aspx?xmlfile=174.xml&filter=PR5377
2) Ceriulli Associates, Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans
3) Funds used in this analysis: AB 2025 Retirement Strategy I, American Century One Choice 2025 Instl, American Funds 2025 Target Retirement R6, AXA Target 2025 Allocation K, BlackRock LifePath Active 2025 Instl, Fidelity Advisor Freedom® 2025 I, Franklin LifeSmart 2025 Retire Target Adv, GuideStone MyDestination 2025 Inv, JHancock Retire Living through 2025 I, JP Morgan SmartRetirement® 2025 Instl, Nationwide Destination 2025 Instl, Putnam RetirementReady 2025 R, T. Rowe Price 2025, TIAA-CREF Lifecycle 2025 Instl, Vanguard Target Retirement 2025 Inv, Vantagepoint Milesone 2025 TM, Voya Solution 2025 Port I, Wells Fargo Advtg DJ Target 2025 R6
4) Zephyr STYLEAdvisor
5) Morningstar as of September 30, 2015
6) *Are 401(k) Investment Menus Set Solely For Plan Participants*; Pool, Siaim and Stefanescu, Journal of Finance, August 2015

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