GOSSELIN CONSULTING GROUP LLC
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Target Date Funds: Evaluating the Underlying Factors

Release date: July 2012

Target date funds ("TDFs") have been rapidly evolving since their inception in the 1990's. In addition to the introduction of new players in the target date market, the construction methodologies employed by those investment managers and the underlying asset classes included in target date portfolios have also continued to evolve. As such, the differences between various target date products have been magnified by the evolving nature of the product set.

In light of these differences, selecting a suite of target date funds can be overwhelming — the factors that go into making a decision can seem endless. By using a simple decision tree to evaluate each factor, plan sponsors can more effectively navigate the levels of decision-making and analysis necessary to satisfy the prudent process requirement imposed on plan fiduciaries when selecting investments on behalf of plan participants.

Demographics

Plan demographics are a key consideration when selecting the appropriate suite of TDFs for your plan. The average age, tenure, risk tolerance, contribution and participation levels, and sophistication of your participant base are all important factors to consider in light of participant behavior dictated by these characteristics. Similarly, the existence or lack of a DB plan offering should also be given consideration, as this is an important factor in how participants view the investments in their DC plan. If your plan has a retirement age that differs from the standard age of 65, this can also be a significant factor in selecting the most appropriate suite of TDFs for your plan.

Perhaps the most critical demographic factor for evaluation is the typical pattern of behavior for participants who have recently retired, as this will inform decisions regarding the most appropriate glidepath approach ("to" or "through") and final vehicle. Evaluating participant behavior over market cycles can also help provide valuable insight into how your participants behave during times of market volatility and uncertainty, and provide direction as to how best to educate participants on the benefits of using a target date fund to weather those difficult periods.

DID YOU KNOW:
As of June 30, 2012 assets in target date funds reached $452.7 billion
[mutual fund and collective trusts]
(Morningstar Direct; does not include custom target date fund assets)

Available Increments: 5- vs. 10-Year Availability

Most target date funds are now available in 5-year increments (i.e. 2015, 2020, 2025, 2030), however some continue to offer only 10-year increments (i.e. 2020, 2030, 2040). Selecting a product with 5-year availability can help participants focus in on the most appropriate fund for their individual investment profile, as their retirement date becomes easier to identify when there is a smaller band around the dates offered. This also reduces the margin for error with respect to ensuring the participant is accurately invested in a fund matching his/her implied risk profile — 5-year increments ensure a participant is typically no more than 2.5 years away from their anticipated retirement date, whereas 10-year increments allow for up to a five year gap based on date of birth versus anticipated retirement date. This becomes especially critical as a participant approaches retirement, where a 10-year band may allow for more equity exposure and/or less inflation hedging than appropriate for someone on the cusp of retirement.

In addition, selecting a product with 5-year availability eliminates the potential need for future participant communication and asset transitions should the product with only 10-year availability decide to expand its suite and offer 5-year increments. Ensuring a TDF manager issues their newest funds in a timely manner is also important, as a delay in issuing the latest vintage (i.e. 2055) in the series can result in the plan's youngest participants ending up in a product that is not age-appropriate long-term.

Level of Customization

Today plan sponsors have the option of customizing a suite of TDFs to meet the needs of their plan, or using an "off-the-shelf" product. The majority of today's TDF assets are invested in off-the-shelf products offered by investment managers who have proprietary recordkeeping organizations — however, this is gradually changing as plan sponsors become increasingly concerned about the fiduciary implications of using proprietary investment products. Also, the scale of many DC plans is now making the use of fully customized TDFs a viable option, as a significant asset base is typically required to make full separate account administration economically viable.

There are benefits and drawbacks to each approach. Off-the-shelf products managed by an investment management firm offer the benefits of brand name recognition, easy access via mutual funds and/or collective trusts, opportunities for low-cost pricing, and access to the thought leadership of investment managers whose sole focus is managing money for investors. Drawbacks of using an off-the-shelf product include increased potential for overlap of underlying proprietary funds, potential lack of a non-revenue-sharing share class, asset bloat, and lack of diversification of underlying managers. It is also difficult to find an investment management firm that has the required skill in each of the underlying asset classes necessary to build a properly diversified TDF.

DID YOU KNOW:
Target date fund assets have more than quadrupled since 2007
(Ibbotson Associates, April 2012)

Custom TDFs provide plan sponsors with the ability to customize the TDFs offered to their participants, and generally use some or all of the investments offered as stand-alone options to participants in the plan. This provides one of the largest benefits to the plan sponsor, as ERISA's fiduciary requirements require plan sponsors to monitor each of the underlying sleeves of a TDF, and by using many/all of the funds offered by the plan the necessary due diligence effort is already part of the ongoing review process. The ability to tailor a plan's TDF options to the demographics of the participant population is perhaps the largest benefit of electing to build custom TDF portfolios.

The mechanism by which a plan sponsor elects to create a custom TDF may dictate the ability to add additional asset classes to supplement the existing asset types represented in the plan. Sponsors can elect to create a separate account product, which incurs the additional cost and oversight associated with separate account administration, making the separate account approach most practical for those plans with a significant asset base. The benefits of this approach include the ability to truly customize the suite of TDFs to meet the needs of the participant base through the addition of esoteric asset classes that may not be appropriate as stand-alone options in the core line-up (i.e. high yield, real estate, natural resources). In addition, sponsors have the ability to make changes to the underlying managers when necessary. An alternative to the separate account approach is the use of a system-driven allocation model. Most recordkeepers can accommodate a client's desire to build custom TDF portfolios through the use of the recordkeeping system. Limitations of this approach often include the inability to add asset classes/funds outside of those offered as part of the core line-up, a potential "all or nothing" requirement for participants' assets (if participants elect to invest in one of these models they cannot invest in any other options offered by the plan), and the disruption of these portfolios any time a change is made to an underlying investment option in the plan. In addition, participants may see their allocation to each of the underlying investment options in the TDF on their quarterly statements instead of the rolled-up portfolio performance, creating a potential source of confusion.

Regardless of whether separate accounts or system-driven model portfolios are used, the plan sponsor must additionally develop the glidepath and underlying asset allocation for each portfolio in the TDF suite. An investment consultant or asset management firm can be hired to do this work, should the plan sponsor lack the qualified internal resources. Naturally there is an expense associated with this effort, as well, which can add to the cost of offering a custom TDF solution to participants.

Portability is another challenge when using a custom TDF product, regardless of the mechanism used to create the TDFs. Should a participant elect to roll their assets from the plan upon termination of employment (either to another qualified plan or an IRA) they lose the ability to remain invested in the custom TDF product, forcing them to re-select an investment strategy under the new plan or account. Conversely, a well-designed and cost competitive custom TDF product can provide incentive for participants to leave their assets in the plan even after they have changed employers or left the workforce.

DID YOU KNOW:
As of December 2011, the five largest target date fund managers represented 84% of target date mutual fund assets
(Strategic Insight research, March 2012)

Active or Passive

Philosophically, plan sponsors must determine if they believe active management or a passive approach is the most appropriate investment strategy for their participant base. This will influence the overall cost of the portfolios offered to participants, as a passive approach typically comes with a reduced fee. Low fees alone do not constitute a sound fiduciary decision, however — plan sponsors must consider whether they believe the underlying asset allocation of the TDFs is the driving factor that will determine the outcome for the participants invested in each portfolio, or if active management oversight and/or a differentiated glidepath will ultimately result in a more favorable outcome, thereby justifying the additional cost.

Some investment managers offer products that blend the use of active and passive management, using index products in what they believe to be the more efficient or costly areas of the market to access. A handful of investment managers also offer their TDF product in both passive and active versions, allowing the plan sponsor to choose the most appropriate offering for their plan based on their beliefs, while accessing the same underlying asset allocation and glidepath regardless of management style.

Single or Multi-Manager

Similar to determining if there is an off-the-shelf solution that meets the needs of a specific plan or if a custom solution is required, it is important to evaluate the appropriateness of single manager versus multi-manager TDFs. This generally comes down to whether there is one investment management firm that you believe can meet the challenge of creating and managing a suite of TDFs entirely in-house, or if a multi-manager product that uses the best-in-class offerings (as determined by the manager) from multiple investment managers as the underlying components of the TDF is more appropriate for your plan.

> **DID YOU KNOW:**
> **Target-date assets are projected to reach $1.1 trillion by 2016**
> *(Cerulli Associates, The Cerulli Edge: Retirement Edition, 1Q 2012 issue)*

Using a multi-manager approach allows for another level of diversification at the firm level, which aligns with the diversification message so often directed at plan participants. Also, a multi-manager approach allows for the hiring and firing (for cause) of underlying managers at the discretion of the team/committee responsible for selecting and monitoring the underlying managers — the ability to do so within a single-manager product may present more of a challenge, as there is no truly neutral party responsible for manager selection and/or portfolio construction. Additionally, many investment management shops do not have alternate products available to substitute in the event that an underlying product fails to meet the necessary criteria — often resulting in a lack of action on the part of the team/committee overseeing the TDFs in a single-manager product set.

Ongoing Management Factors

There are many factors that go into the ongoing management of a TDF product that warrant consideration when selecting a suite of TDFs. Rebalancing frequency and technique, cash flow distribution, application of a tactical overlay, and any asset allocation overlay/wrap fees are all important elements of ongoing management. In addition, evaluating any changes that have been made to the product over time is important, so that the context around historical performance and risk profiles is accurately understood. The number of changes made, or lack thereof, can also be an indicator of potential likelihood of changes to come.

Benchmarking is also an important aspect of evaluating TDF managers. While it is important to look at the high-level performance of each target date fund, ensuring that the manager can provide a detailed custom benchmark that ties specifically to the underlying products being used in their stated target allocations is important for the purposes of due diligence. Many investment managers will use a generic mix of generally accepted market indices for performance evaluation purposes (i.e. 60% S&P 500 / 40% Barclays Aggregate Bond Index), which may not be an accurate representation of the underlying sleeves of the fund being evaluated. Understanding the performance of the underlying components versus their individual benchmarks is a critical part of the prudent process used to evaluate managers as a plan fiduciary. Any tactical overlay should also be carefully evaluated. Lastly, evaluating the risk of each portfolio in light of plan demographics should also be part of the ongoing benchmarking process.

Underlying Investments

Understanding the underlying investments used by a TDF manager is another important consideration when selecting a TDF product set. This involves looking at underlying vehicle type, asset class exposures (on an absolute and relative basis), and number of underlying strategies.

The type of underlying vehicles that the manager is investing in is important for several reasons — pricing, potential exposure to other investor types, and transparency are key factors. The use of qualified-only vehicles such as collective trusts often helps to not only lower expenses, but also eliminates the noise created by retail investors. Conversely, the ability to readily access information on the underlying components of the TDF makes mutual funds a compelling alternative.

> **DID YOU KNOW:**
> **Nearly 64% of plans now offer target date funds to their participants**
> *(PSCA's 54th Annual Survey of Profit Sharing & 401(k) Plans, October 2011)*

Asset class exposure is perhaps the most critical element of any target date product offering. The manager's approach to asset class design is generally the distinguishing feature between the various TDF managers and generally defines the level of risk associated with the TDF suite. In a marketplace crowded with options, how a manager approaches the asset class decision sets them apart from their competitors and aligns them with plan sponsors who see their philosophy reflected in the manager's approach. Selecting a TDF manager that acknowledges the need for more than a simple mix of traditional domestic equities and bonds and appropriately diversifies into complementary asset classes (i.e. commodities, TIPS, etc) and various geographies is critical.

More underlying options does not always translate to better product construction or enhanced diversification, however. Plan sponsors must be careful to avoid TDF managers who have significant overlap between underlying products (i.e. multiple domestic large-cap growth funds) — this can dilute performance, overexpose participants to a particular asset class, and/or signify that the manager is looking for another avenue to seed funds or gather assets in a fund that is failing to do so on its own. Such unnecessary overlap also increases the oversight and due diligence burden on the plan fiduciary.

It is also imperative that plan sponsors have the ability to individually analyze the underlying components of a TDF product. Access to data on the individual sleeves that make up the TDF portfolio must be made available to plan sponsors and their consultants in order to effectively fulfill the duty to monitor the funds offered to participants. An investment manager than cannot make this information available to a plan sponsor should be eliminated from consideration.

Glidepath Construction

The shift, or roll-down, in underlying asset class allocation as the retirement date nears is known as the fund's "glidepath". This roll-down schedule varies widely between TDF options. Understanding the nature of each product sets' allocation shift is crucial to finding a product appropriate for a particular plan's participant base. There are two elements that require examination — the composition of the product prior to the retirement date, and the approach used following the achievement of that retirement date.

Target date funds are often referred to as having an aggressive, moderate, or conservative glidepath. This is generally described as the equity/bond mix over time — for example, a fund with a higher equity exposure over time has traditionally been considered more aggressive than one with a higher bond exposure. However, this should not be the only factor considered when evaluating the nature of the glidepath. The underlying exposures within each broader asset class should also be considered — for example, within domestic equity, how is capitalization exposure managed? Does the fund invest equally across large-, mid-, and small-cap, or is the fund market weighted, leading to a higher exposure to large-cap equities? International exposure is another important factor for consideration — how much of the overall equity exposure is in international equities? Within the international equity exposure, how much is dedicated to emerging markets versus developed market exposure? Does the fund take future market dynamics into consideration when determining its risk exposure (as risk profiles of the past may not always remain the same in the future)? As the funds move along the glidepath and near retirement, how do these allocations shift? These are all important concepts when evaluating the glidepath of a TDF manager. Plan sponsors must be sure to evaluate not only the equity/bond mix, but the building blocks that comprise each of those allocations.

Equally as important as the roll-down leading to retirement is the approach used upon reaching the implied retirement date in the name of the fund (i.e. 2045 Fund). Does the TDF employ a "to" or "through" approach? In simple terms, does the fund stop shifting its allocations upon reaching the implied retirement date ("to"), or continue to roll-down following the implied retirement date ("through")? Many funds continue to shift allocations beyond the retirement date implied by the fund's name, in order to better account for longevity risk (the risk of outliving one's assets) in light of today's increasing life expectancy. Determining which is the more appropriate approach for a particular plan can depend on the typical behavior of a plan's participants at retirement — if participants tend to take all of their money out of the plan at retirement, a "to" approach may be more appropriate; if they tend to remain in the plan while taking required minimum distributions, a "through" approach may be a more diligent approach. In either case, the final vehicle used must also be understood. Traditionally the final vehicle is simply another mutual fund/collective trust with a static allocation, however, increasingly investment managers are looking at using various annuity-like vehicles to assist participants with the draw-down/de-cumulation phase in retirement. Ensuring an understanding of the manager's intentions for the final vehicle is therefore critical.

Without question, target date funds are gaining momentum in DC plans and will continue to gather assets in the coming years. The importance of these investments is only magnified by their status as Qualified Default Investment Alternatives (QDIAs) under ERISA. Ensuring a firm grasp on the differentiating factors of these products and understanding how those factors should take participant behavior into consideration is a key element of effectively evaluating and selecting a suite of TDFs for your participants. By breaking down the TDF due diligence process into a series of smaller decisions/evaluations, plan sponsors can more effectively navigate the levels of decision-making and analysis necessary, and ultimately select a suitable target date product on behalf of plan participants.

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TARGET DATE FUND SELECTION
DECISION TREE

Many factors go into evaluating target date funds. Listed below are some of the key decision points that should be carefully considered when selecting the appropriate suite of funds for your participant population:

PLAN DEMOGRAPHICS
Factors to consider: Sophistication of participant base, average age, average tenure, average contribution/participation rates, typical post-retirement behavior, risk appetite, historical behavior patterns, existence/lack-of DB plan, unique plan characteristics (i.e. retirement age other than 65)

AVAILABLE INCREMENTS: 5- vs. 10-YEAR AVAILABILITY
Factors to consider: Availability of 5-year and/or 10-year increments, typical roll-out schedule for latest vintages

LEVEL OF CUSTOMIZATION
Factors to consider: Custom vs. off-the-shelf products, vehicle type, costs, limitations, share class availability, revenue share considerations, custom glidepath development costs/resources, portability

ACTIVE OR PASSIVE
Factors to consider: Philosophical approach to investment design, cost

SINGLE OR MULTI-MANAGER
Factors to consider: Ability of investment manager(s) to manage investment products across the spectrum of underlying investments, firm risk, diversification potential

ONGOING MANAGEMENT FACTORS
Factors to consider: Use of tactical overlay, potential additional asset allocation fees, cash flow distribution & rebalancing techniques, benchmarking considerations, history of product enhancements

UNDERLYING INVESTMENTS
Factors to consider: Vehicle type, sub-asset class exposures, number of underlying strategies, overlap potential

GLIDEPATH CONSTRUCTION
Factors to consider: Nature of glidepath (aggressive, moderate, conservative), roll-down schedule, “to” vs. “through” approach, sub-asset allocation, equity vs. bond allocations, small vs. large equity allocations, international vs. domestic allocations, developed vs. emerging market international allocations, final allocations, final vehicle type

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