Questions a Fiduciary *must* be able to answer about their Target Date Funds (TDFs)

In February of 2013 the U.S. Department of Labor (DOL) issued a Fact Sheet titled Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries. **The Fact Sheet's purpose was clearly stated: "…to assist plan fiduciaries in selecting and monitoring TDFs and other investment options in 401(k) and similar… plans".**

The newly enacted 2016 DOL rule, commonly referred to as the "fiduciary rule", made just about every retirement plan professional a fiduciary on 401(k) plans which means *you* must know and follow the processes found in this Fact Sheet. We have broken this process down into simple steps and lend additional insights throughout.

We and the DOL have five main issues with the first generation of TDFs and how the industry uses them today. In short, for *each* plan you work with, you must:

1. Establish an objective process for comparing, selecting and reviewing your TDFs.
2. Understand the fund's investments and how they change over time.
3. Determine if the expenses are appropriate for the services given.
4. Know if the TDFs chosen have the ability to get defensive in market failures.
5. Develop effective employee communications.

Comparing, Selecting, Reviewing and Documenting

Brand recognition is not a valid selection criteria. We explore in depth some of the selection criteria below, but know the DOL wants, on an annual or at least a biennial basis, a fair process of selection and review of TDFs and all 401k fund choices. Most importantly, you must document your decisions.

Start with the plan's Investment Policy Statement. What are the demographics of the employee pool? What does the sponsor want and why? What do the employees want? (Ask!) Hold a meeting and explain the differences in the TDFs you are offering. Some may want the lowest possible expense and don't care about anything else. Others would rather pay a bit more and get active management, asset allocation, more aggressive/conservative glide-paths and other attributes that are more appropriate and/or important to them.

Under the new regulation, the DOL is asking fiduciaries to review their TDF choices on an absolute and relative basis. Gone are the days of one size fits all. Proprietary fund pallets (all fund choices from one fund family) are specifically questioned in the DOL Fact Sheet. Is the TDF family offered only in the plan because of a bundled/packaged 401(k) or are they the best fit for the plan?

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Understand the fund's investments

The general goal of TDFs is to have assets grow over time with "risk appropriate" investments. The fiduciary's role includes "understand[ing] the principle strategies and risks of the fund, or any of the underlying asset classes or investments that may be held by the TDF". What to look for:

Equities

1. TDFs vary greatly in their construct. For instance, of all the 2030 TDFs, what is the range or variance of equity ownership? It is almost 50%[1]. One TDF manager can have 85% equity in their 2060 TDF and another 35%. We can debate the wisdom of these percentages but that is not the point! How much equity is held in the TDF family that you recommend? Do you know?
2. TDF managers can and do change the holdings. In the summer of 2015, right before the August market drop caused by the Chinese devaluing the Yuan, one of the "big 3" TDF managers increased their domestic equity by 15% on all but two of their TDFs and another increased their international equity 10% across all of their TDFs. Did you know this? Did your sponsors? Did your participants? Ask the TDF manager to know the frequency of review and change, what the process for that change is and how they communicate it to investors. In essence, how is the money managed?
3. Does your TDF family manage to retirement or through retirement? If so, what amount of equity or risk assets are present as your clients approach retirement? Is this what they want?

Bonds

The DOL Fact Sheet continues: "As the target retirement date approaches, the fund's asset allocation shifts to include a higher proportion of more conservative investments, like bonds and cash instruments, which generally are less volatile and carry less investment risk than stocks". Have you ever looked at the bond holdings of your TDFs? What percent are in long term (20-30+ year) bonds, high yield (junk) bonds or emerging market bonds? Not one investment professional we know, using the prudent man rule, would classify these bond types as "more conservative" investments. In fact, junk bonds often act more like equity in times of market duress. If you don't know what types of bonds are in the TDFs you recommend, how would your sponsors and participants know?

Can your TDF manager avoid rising interest rates? Can they avoid the majority of a bond bear market by significantly shortening duration or by going to cash? Rates won't stay low forever. How will your clients respond when interest rates go up and bond values drop? It has been decades but bonds have bear markets too! How will your TDF manager seek to protect these assets for those who have the most to lose…employees who are nearing retirement?

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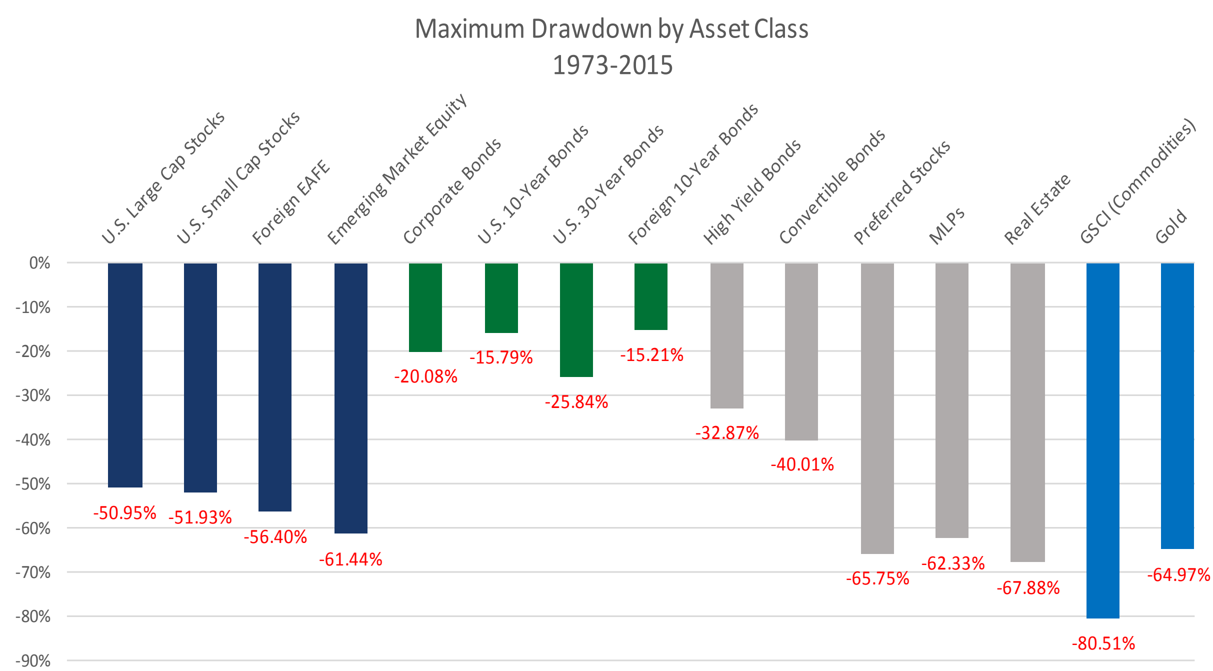
Expenses

Yes, lowering unnecessary expenses will increase investor returns and this is important to all investors. This is one of the thrusts of the new DOL rule and cutting down all-in plan fees as high as 3-4% is warranted. However, to paraphrase an Undersecretary of the DOL, "Expenses are not everything. The lowest cost TDF may be a bad fit and inappropriate for a plan". The keys are suitability and value. What are you getting for the fees provided? To quote the 2013 Fact Sheet: "Added expenses may be for asset allocation, rebalancing and access to special investments that can smooth returns in uncertain markets...". Can your TDFs smooth the ride in uncertain markets?

Is a low cost, index based TDF family going to go off a cliff when the markets do? Most participants want and expect their portfolios to be shielded from large losses as they approach retirement. Index-based TDFs offer little to no protection against large losses. Dynamic TDFs can. The key is to discuss the options with the sponsor/employees and document their (now) informed preference.



Defense

In 2008, the "big 3" TDF 2010 funds lost between 21-27%. How would your sponsors and employees feel if they got within two years from retirement and lost a quarter of their retirement savings? Most would no longer be able to retire. Every asset class goes through periods of failure. Why leave your clients vulnerable to these inevitable downturns?

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Today, it seems to be in vogue for TDFs to add some of the grey and light blue asset classes shown below. Note their drawdowns are bigger than the dark blue, equities! How much exposure to "alternative asset classes" do your TDFs have? Is this what your clients want?

Again, we find that sponsors and participants alike want and expect their principal to be more sheltered from large losses as they get closer to retirement. They know their investment time horizon is shrinking and it is prudent to manage risk accordingly. Revisit the equity and bond sections above. Knowing what is in the TDFs will give you a solid foundation to your process. It will also help you properly educate the employee participants.

Document

In today's litigious society, one of the best defenses comes with documenting your process and reasoning in writing. It is also required by the DOL. How did you reach your decision on each investment option? Would your clients agree with you if challenged?

Employee/Participant communication

Finally, all of this needs to be communicated to the participants. If they don't understand the glide path and holdings, they are likely to be disappointed at some point. Unhappy participants translates into liability for plan fiduciaries and unhappy sponsors. Ask to speak with a sample employee pool (usually at least some will take great interest). Communication starts at the beginning of the relationship with interaction, education and providing appropriate choice. Empower your clients!

For advisors providing retirement plan services, yes, you are a fiduciary. In order to abide by the new DOL requirements you must be sure to educate yourself and your team. While the process is easy to do, you have to do it for each and every plan. This is where BCM can help. We have started a TDF database to answer some of these questions. Let us know how we can assist you!

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Disclosures:

[1] 2016 Target-Date Fund Landscape, Morningstar, April 12, 2016; page 83.

The views and opinions expressed throughout this presentation are those of our Portfolio Manager as of August 31, 2016. The opinions and outlooks may change over time with changing market conditions or other relevant variables.

Source for drawdown chart: Global Asset Allocation (Chapter 3) via mebfaber.com, Meb Faber, March 6, 2015. Bloomberg for the period 1973-2015. The data shown for Convertible Bonds, Preferred stock, High Yield Bonds and MLPs is sourced by Bloomberg. They use the same end date as the rest of the asset classes (12/31/15), but have different starting dates due to the fact the indices for these asset classes did not exist in 1973. Convertible bonds is for the time period starting on 6/17/1986, Preferred stock data starts 9/9/2003 and the MLP data begins 12/21/1995. The returns shown are "Nominal Returns" for the time period specified. "EAFE" represents the regions of Europe, Australasia and Far East.

The "big 3" Target Date Funds were selected based on highest total assets among target funds with a 2010 target date. Fund "A" is Vanguard, Fund "B" is Fidelity and Fund "C" is T. Rowe Price. Returns cited are for calendar year 2008 and the sources are the respective fact sheets of the TDFs.

If you would like to read the DOL 2013 TDF Fact Sheet please click on the link below:
https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf

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