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Why Target Date Fund Oversight Matters

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Money management giant Vanguard began tracking the popularity of funds with professionally managed allocations — primarily target date funds (TDFs) — in 2003. Over the years, the organization has reported a steady growth of their prevalence in defined contribution retirement plans. As of the end of 2017, 58% of participants invested in a TDF, and Vanguard projects that that number will hit 77% by 2022.

The QDIA Factor

One simple explanation of the growing dominance of TDFs is that they're one of the four categories of qualified default investment alternatives (QDIAs) permitted under the Pension Protection Act of 2006.

Vanguard's 2018 *How America Saves* report indicates that TDFs were the QDIA for 81% of the 1,900 plans and 4.6 million participants for which the organization provides recordkeeping services. In fact, 90% of participants joining a plan for the first time last year invested solely in a professionally managed allocation fund. And 97% of participants in plans handled by Vanguard have access to a TDF. (92% of the plans offer TDFs.)

Because TDFs aren't plan sponsors' only QDIA option, fiduciaries whose plans use TDFs as their QDIA should exercise due diligence to ensure a TDF is right for their participants. Here are some common criticisms to consider:

One size doesn't fit all. TDFs' implicit "one-size-fits-all" (participants of the same age bracket) structure can lull retirement investors into complacency with respect to their responsibility for understanding and monitoring investments. In addition, individuals' financial circumstances vary and have implications for optimum asset allocation. Participants who don't fit the TDF's demographic profile could be poorly served.

Bonds aren't risk-free. TDFs generally treat bonds as a more conservative investment than stocks, and shift their allocations more heavily to bonds as the plan participant approaches and enters retirement. But bonds aren't risk-free. They can become overpriced and suffer a market "correction" just as much as stocks.

Portfolios generally diversify. TDF portfolios generally diversify using asset classes that are typically "noncorrelated": When one goes down in value, the other tends to go up. Stocks and bonds are considered noncorrelated asset classes. However, sometimes they move in the same direction. That can be good as well as bad but, in both cases, doesn't provide the intended diversification.

Fees are expensive. Because TDFs typically are a fund of funds, you can wind up paying two layers of fees. Those fees are more substantial for actively managed funds than for passive ones, of course. Thus, some TDFs are expensive from a fee standpoint, although both passive and active fund managers have been continually reducing their fees over the past several years.

Participants' Responsibility

In 2013, the Department of Labor (DOL) released guidance titled "Target Date Retirement Funds — Tips for ERISA Plan Fiduciaries." In it, the DOL noted concern that participants who choose or are defaulted into TDFs can become complacent about their retirement investments. The DOL warned that participants who are responsible for investing their individual accounts need to understand TDF basics just as plan sponsors do.

For its part, Vanguard appears confident that the benefits of TDFs — particularly when participants are automatically enrolled in them — outweigh possible concerns. Behavioral finance research, according to Vanguard, shows among other things that, when left to their own devices, participants:

- Have weak planning skills and find it difficult to defer gratification,
- Take the default or "no decision" choice when faced with a complex choice and are unsure what to do, and
- Deal with a difficult choice by deferring it to another day.

With plan sponsors auto-enrolling participants into TDFs in greater numbers in recent years, the largest proportion of participants that invest exclusively in TDFs consists of those who are relatively young and, thus, have lower than average account balances and job tenure. Even so, according to the Vanguard report, two-thirds of plan participants invest exclusively in a single TDF, and 26% invest in a TDF plus other funds.

Time to Decide

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Will TDFs take over the world of defined contribution plans? Perhaps not completely, though the trends point in that direction. Plan sponsors should study the DOL's guidance to make sure they and their participants understand the overall pros and cons of TDFs — especially how any given TDFs are managed and likely to perform.

TDF Diversity

To put matters into perspective, most of the criticism of target date funds (TDFs) isn't about the basic concept, but about the distinguishing features of particular TDFs. Such differences — including glide paths, investment strategies and fees — "affect the way a TDF performs," says the Department of Labor (DOL).

The DOL has expressed concern that many plan sponsors may take an "if you've seen one TDF, you've seen 'em all" posture. In response, it issued a set of "Tips for ERISA plan fiduciaries" on how (and why) to check under the hood of each TDF fund array. This advice is still valid.
Instead of just beginning its tip sheet with a checklist of TDF evaluation criteria, the DOL urges plan sponsors to "establish a process for comparing and selecting TDFs," as well as periodically reviewing selected TDFs. Remember, TDFs are no different from other managed investments in that their strategies, management teams, fee structure and performance against suitable benchmarks aren't static.

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