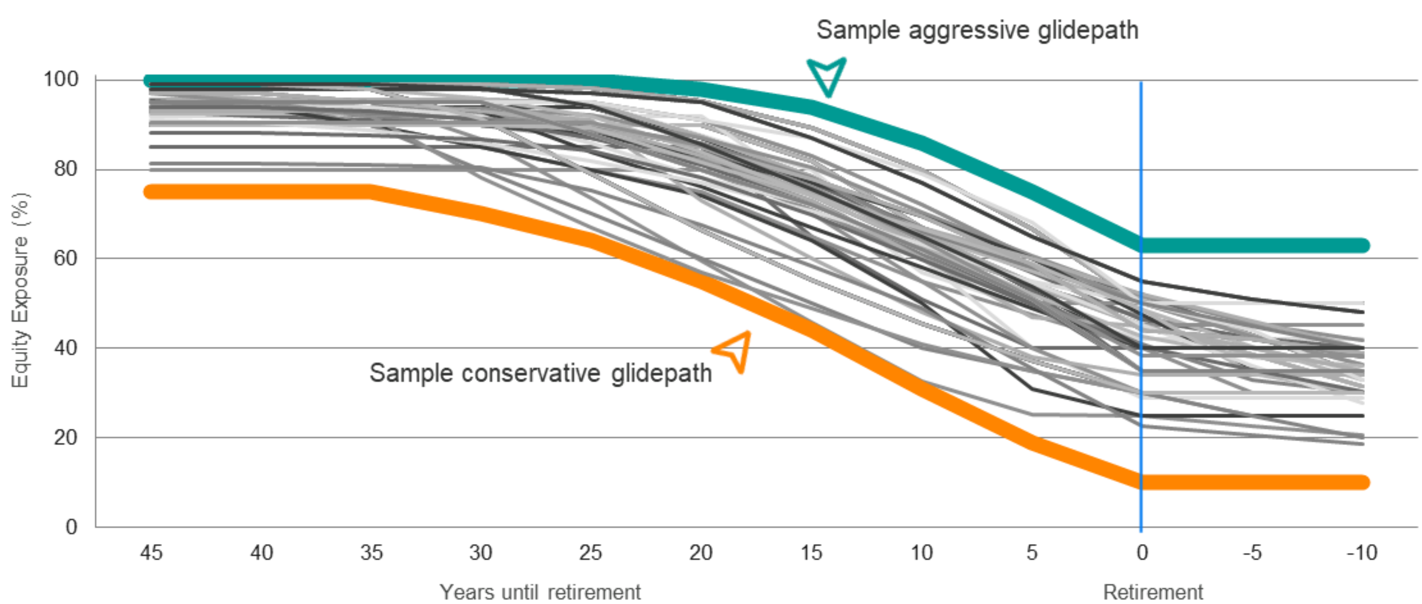
Do you have the right TDF for your plan?

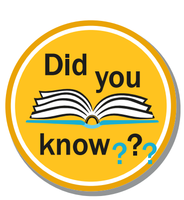
Target date funds (TDFs) represent one of the most critical investment decisions fiduciaries must make about their retirement plan. While TDFs represent a growing share of retirement plan assets (83% of participants invest in TDFs representing 63% of new contributions[1]) and have become the go-to "simple" solution for most participants the reality is that these investments have a high degree of variability and are commonly misunderstood. Equity exposure at retirement age can vary by more than 50% between the most aggressive and most conservative TDF series in the marketplace. **Do you know the risk level of your plan's TDF glidepath?** These complexities, coupled with the prevalence of TDFs being designated as a plan's Qualified Default Investment Alternative (QDIA), make the TDF selection process anything but "simple" for fiduciaries.

TDF Glidepath Universe



Are you checking off all your TDF fiduciary boxes?

While many fiduciaries rightly consider performance and fees when selecting a TDF, a prudent process is decidedly more comprehensive.



Did you know that the Department of Labor (DOL) asks fiduciaries to align the TDF glidepath to participant characteristics as part of a prudent TDF selection process? In their February 2013 "Tips for ERISA Plan Fiduciaries", the DOL writes "You should consider how well the TDF's characteristics align with … characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns."

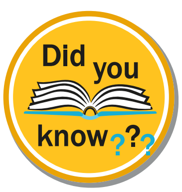
This TDF "fit" analysis is a critical first step to ensure the TDF's glidepath matches the plan's overall demographics before considering other investment related factors. For example, a TDF may have strong performance and low fees, seemingly making it a prudent choice, but its glidepath may be too aggressive (or conservative) for the plan leaving potential for unnecessary and unintended fiduciary and/or investment risks.

Given the variety in TDFs available in the marketplace today, there is likely to be an adequately performing and competitively priced TDF that closely aligns with a plan's fact set, it is just a matter of going through a prudent process to find it. Importantly, this process should be well documented, another point of emphasis from the DOL's tips.

Why does TDF glidepath "fit" matter?

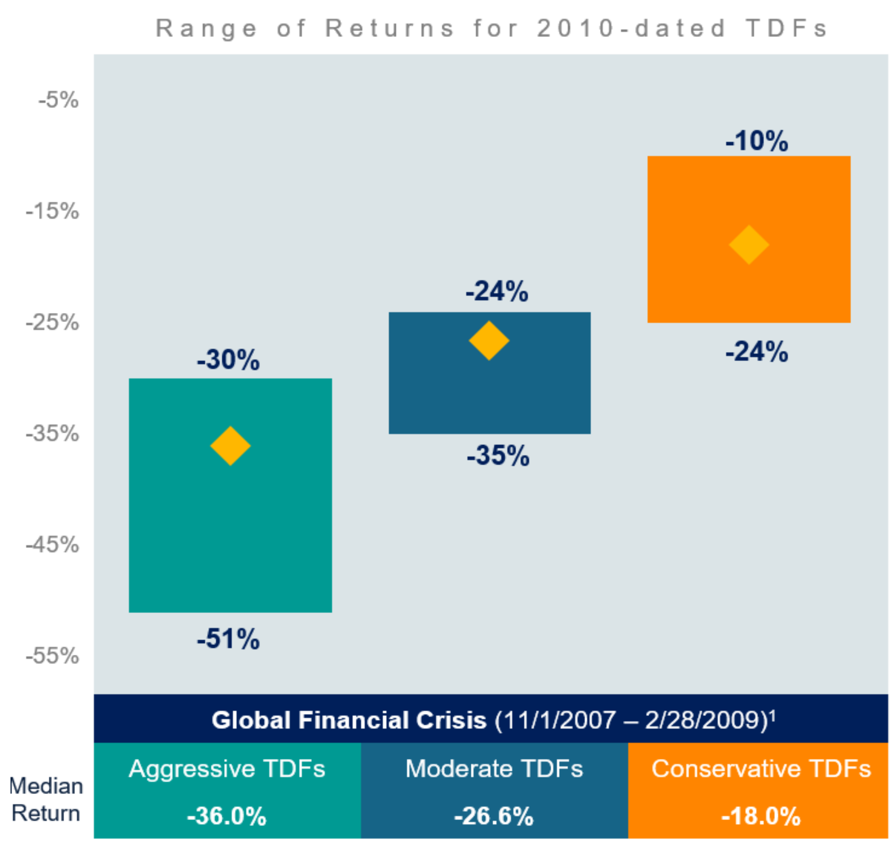
Failure to go through and document a TDF fit analysis can lead to serious unintended consequences for both fiduciaries and plan participants. Since TDFs are so heavily relied on by so many participants to invest their hard-earned retirement savings and the fact that TDFs are oftentimes designated as QDIA, decisions related to the TDF arguably carry more weight and come with added scrutiny.

There is no sign retirement plan litigation is slowing down, and savvy plaintiff's attorneys are following the money towards TDF selection as a potential target. Additionally, the potential impact on a participant's retirement readiness is significant. If a plan's TDF is too aggressive (based on specific plan demographics), participants may be exposed to unnecessary investment risk that could lead to significant losses just before retirement.

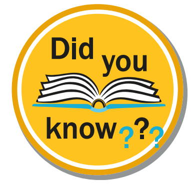


Did you know that the median "aggressive" 2010-dated TDF drawdown during 2008 financial crisis was 36%, with extreme examples of 50%+ drawdowns[2]?

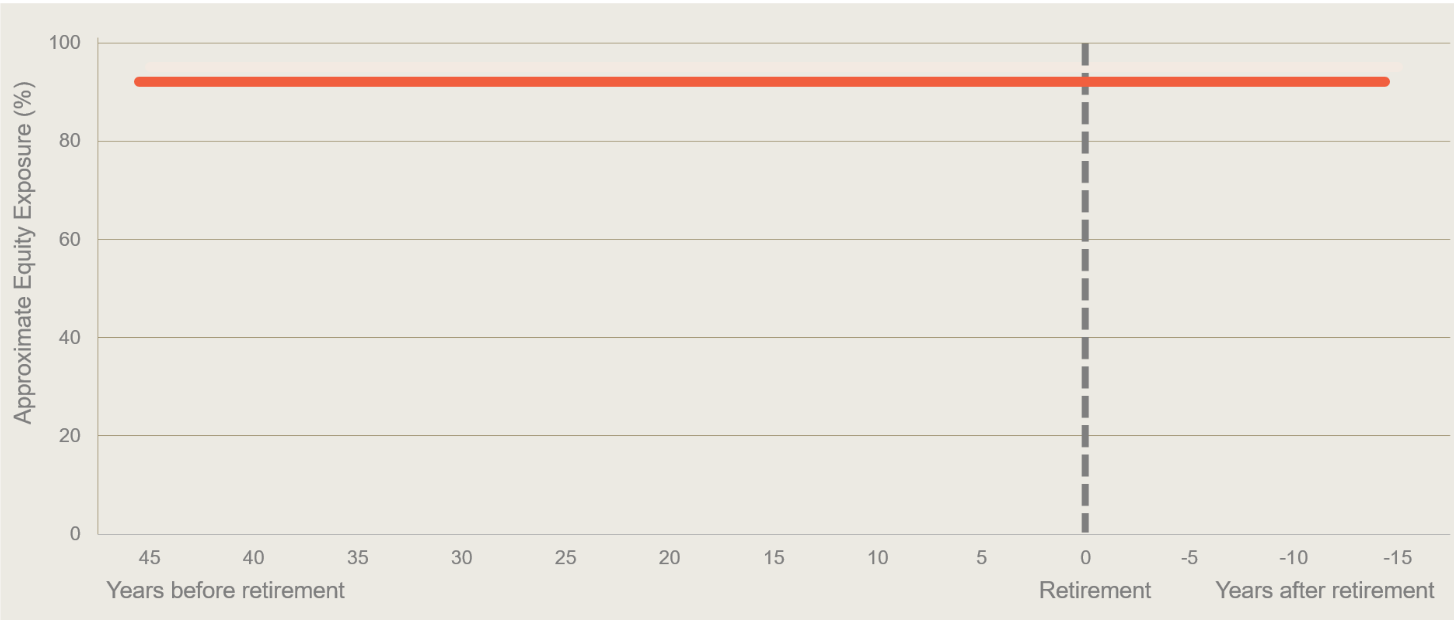
This has a potential snowball effect of leading to delayed retirement and associated workforce costs (wages, healthcare, worker's compensation, etc.). To make matters worse, when there are significant market drawdowns, investors tend to leave the TDF and move to cash which serves to "lock-in" losses. Similarly, if a plan's TDF is too conservative then participants may not achieve the necessary investment growth to be adequately funded for retirement leading to the same snowball effect.



Why should I not simply pick the best performing TDF available to my plan?



This is certainly tempting to do but goes against the very purpose of a TDF. **Did you know that TDFs, by definition, do not maximize return?** The important factor to remember, of course, is risk. Generally speaking, the more risk an investment takes, the higher the expected return. A TDF that wanted to maximize return would have a glidepath that looks something like the below: a straight line at nearly 100% equity.



You might be thinking "This doesn't look like a TDF… the glidepath doesn't slope down as it approaches retirement." You'd be exactly right, this doesn't look like a TDF because no TDF in the industry is structured this way. The purpose of a TDF is to manage risk throughout a participant's life, beginning with higher risk when young to maximize growth potential (higher risk is acceptable because there is enough time to make up for potential losses) and reducing risk as retirement approaches as the focus shifts to preserving the hard-earned retirement savings accumulated thus far. Since TDFs systematically reduce risk over time (thus reducing expected return), TDFs by definition do not maximize return. As mentioned earlier, different TDF managers take varying levels of risk throughout the glidepath, but they all get more conservative over time reflecting this general concept. Thus, if a TDF's goal is to appropriately manage risk (not maximize return) then it makes sense to emphasize aligning your plan's risk profile with available TDF glidepaths rather than selecting a TDF with the highest returns.

How does conducting a TDF fit analysis improve participant outcomes?

It is logical and intuitive that a more personalized allocation is advantageous for participants. In fact, industry research assigns a value of 0.13%-0.82% for this personalization[3]. By conducting a TDF fit analysis you are effectively doing this at the plan level, making sure the TDF aligns with your average demographic. This value typically outweighs the fee differential of similarly managed TDFs (active compared to active, index compared to index) and unlike performance, is consistent regardless of market swings.

How do I determine which TDF glidepath fits my plan?

Generally, participants that are adequately funded for retirement can afford to de-risk to a greater degree as they approach retirement (more conservative glidepath better fit) whereas underfunded participants may need to continue to take more investment risk to compensate for the shortfall (aggressive glidepath better fit). Fiduciaries can gather data around the participants' average savings rates, account balances, and potential income from other company sponsored retirement plans to help determine participants' overall funding adequacy. It may also be useful to consider participant behaviors, withdrawal patterns, and overall risk tolerances. Naturally, individual participant data may vary considerably from a plan's average. When this is the case, it is important to consider "misfit risk", which identifies when a plan's best-fit TDF risk level assumes more risk than what is appropriate for high savers and/or not enough risk for low savers.

At [INSERT FIRM NAME], we are dedicated retirement plan advisors who are well equipped to help you navigate the TDF fit and selection process. Please reach out with any questions or to discuss how we can run a TDF fit analysis for your plan.

[1] Vanguard "How America Saves 2024"
[2] Morningstar Direct
[3] Empower, Evaluating the impact of a retirement managed account, 2020 and Morningstar; Stop Guessing: Using Participant Data to Select the Optimal QDIA.

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