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Using Asset Allocation Vehicles as Custom Target Date Funds – *Navigating the ERISA Landscape*

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What is a Custom TDF?

Like any TDF, it is an investment vehicle that consists of equities and fixed income and that grows more conservative as a participant ages.

It is “custom” because it is tailored to meet specific needs of participants and the objectives of the plan.

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Why Consider TDFs?

The DOL Tips say that fiduciaries should ***"inquire about whether a custom or non-proprietary target date fund would be a better fit*"** and that ***"a Custom TDF may offer advantages"*** to plan participants.

Source: Tips for ERISA Plan Fiduciaries, U.S. DOL Employee Benefits Security Administration, February 2013.

Tips from DOL

“Some TDF vendors may offer a pre-packaged product which uses only the vendor’s proprietary funds as the TDF component investments.

Alternatively, a “custom” TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan’s existing core funds in the TDF.”

Tips from DOL

“Nonproprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants’ exposure to one investment provider.”

Custom TDFs

Custom TDFs typically consist of the plan’s designated investment alternatives (DIAs), which should be:

- Prudently selected and monitored.
- Reasonably priced.

Custom TDFs may also include investments that are not in the plan’s line-up, but only if the Custom TDF is a managed account or a DIA.

DOL Tips: Prudent Selection and Monitoring of TDFs

The DOL guidance says:

> *"You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates . . . the possible significance of other characteristics of the participant population, such as participation in a . . . defined benefit pension plan . . . , salary rates, turnover rates, contribution rates and withdrawal patterns."*

Prudent Selection and Monitoring of Custom TDF

In selecting the Custom TDF (or constructing the Custom TDF), adviser should consider:

- Asset classes and allocation
- Underlying investments
- Fees and expenses, including reasonableness of expenses of the underlying investments
- Glide Path

Asset Allocation and Glide Path

Consider the shape of the glide path -

- What is the Custom TDF's asset allocation when it is most focused on growth?
- What is the asset allocation at the target retirement date?
- When does the asset allocation reach its most conservative allocation - at the target date (a "to approach") or a number of years after the target date (a "through approach")?

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Compensation Structures

- PTE arises when adviser’s compensation varies based on the advice given
- Frost advisory opinion –can receive compensation for investment recommendation if it is fully applied on a dollar-for-dollar basis to offset plan advisory fee or credited back to plan
- 408(b)(2) Disclosure

Custom TDFs as Qualified Default Investment Alternatives (QDIAs)

A QDIA protects plan sponsor from liability for investing participant's account when participant fails to do so.

However, the Preamble to the QDIA regulation says: "The selection of a particular qualified default investment alternative (*i.e.*, a specific product, portfolio or service) is a fiduciary act and, therefore, ERISA obligates fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries."

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Relevant QDIA Investment Categories

- Age-based model portfolio
- Managed account (based upon age)
  - But – managed account must allocate only among investments in the plan's line-up

A Custom TDF as QDIA

A QDIA must be:

- A mutual fund; or
- Managed by 3(38) investment manager or plan sponsor (as a fiduciary).

Participant Disclosure Rules

If the custom TDF is a designated investment alternative (DIA), participants must be given detailed information about expense ratios, performance history, portfolio turnover rates and more.

Some, but not all, recordkeepers can compile and report this information to plan sponsors and participants.

Participant Disclosure Rules

But, a custom TDF isn’t a DIA if it is:

- Asset allocation service; or
- Designated investment manager (DIM) managed account service.

Asset Allocation Service

- Must be clearly presented to participants as an investment service to help participants allocate among the plan's DIA
- Cannot be unitized - it does not have its own trading value and operate like an investment
- Cannot include investments other than DIAs.

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Participant Disclosure of Asset Allocation Service

The disclosure must clearly explain how the service functions and how it differs from the DIAs.

The disclosure should also include information about the asset allocation, glide path, re-balancing, removal and replacement of DIAs.

Participant Disclosures Rules

DIM managed account service:

- Must be a 3(38) discretionary investment manager.
- Designated by plan sponsor to manage participant accounts.
- Requires investment strategies on a participant-by-participant basis.

Disclosure: Must describe the DIM services and fees.

QUESTIONS?

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