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Rethinking Target Date Funds: Who Needs Them and How To Compare Them

Presenters:
Blaine Aikin, AIFA®, CFA, CFP®, Executive Chairman, fi360
John Faustino, Chief Product & Strategy Officer, fi360

Topics

- Overview of the TDF marketplace
- Two due diligence processes
  - Which type of QDIA to use
  - Which product/provider to choose
- A potentially better way to evaluate QDIAs
  - Participant profiles
  - Glide path analysis
  - Investment analysis
- Implications
- Questions and discussion

Overview of the TDF marketplace

- 80% of all 401(k) plans elect to use a QDIA[1]
- 75% of all QDIAs are TDFs[1]
- $1.1 trillion invested in TDF QDIAs (2014)[2]
  - $700 billion in mutual funds
  - $400 billion in CITs and Pooled Separate Accounts
- > $2 trillion invested in TDF QDIAs by 2020[2]
- Three dominant providers of “off-the-shelf” TDFs
  - Fidelity
  - Vanguard
  - T Rowe Price

Sources:

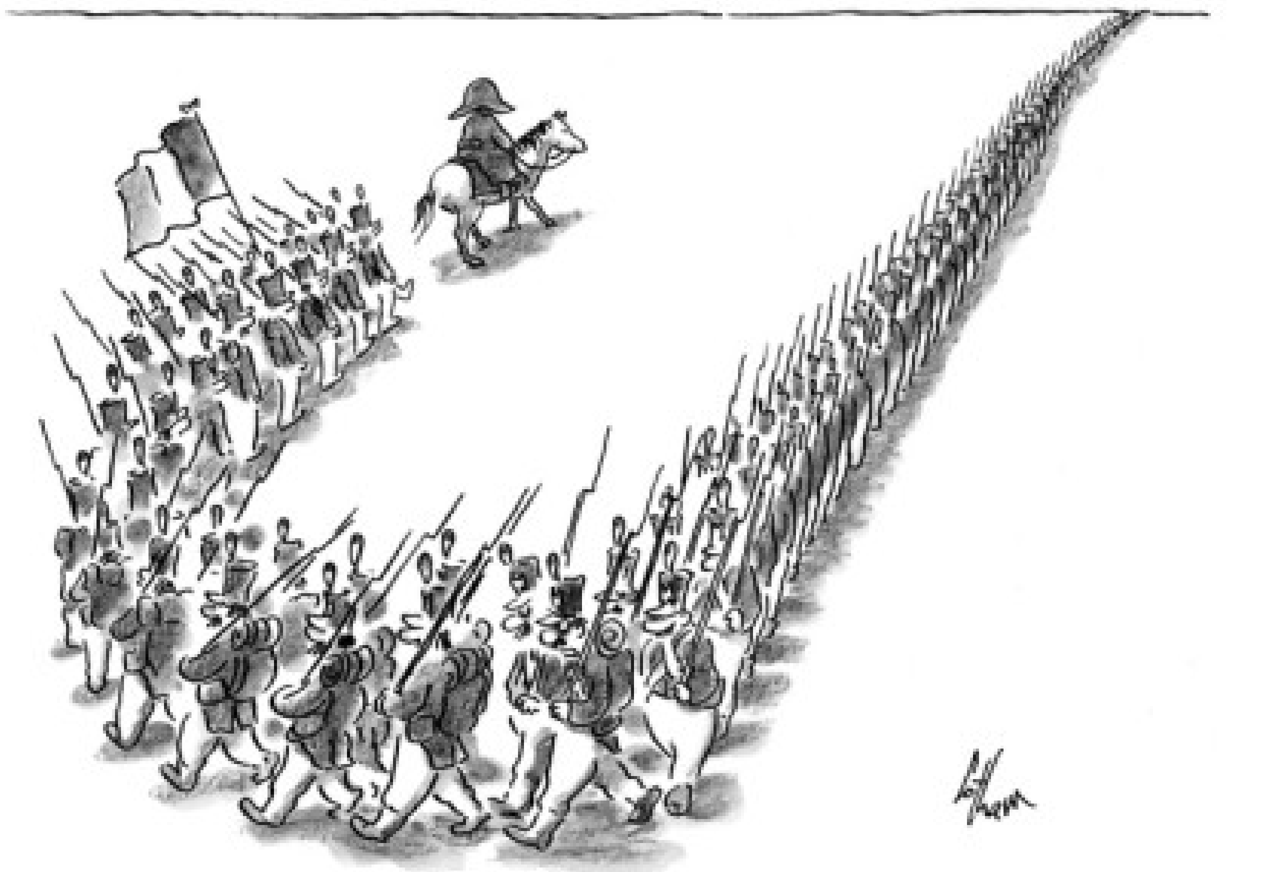
1. Plan Sponsor Council of America 2015 Survey
2. Brightscope Survey and blog post 2015

Evolution of target date design

1	Single Manager	Multi-Manager/ Open Architecture
2	Stocks and Bonds	Plus Nontraditional Asset Classes
3	Static Allocation	Dynamic Allocation
4	Active or Passive	Active and Passive
5	Accumulation	Accumulation Through Distribution

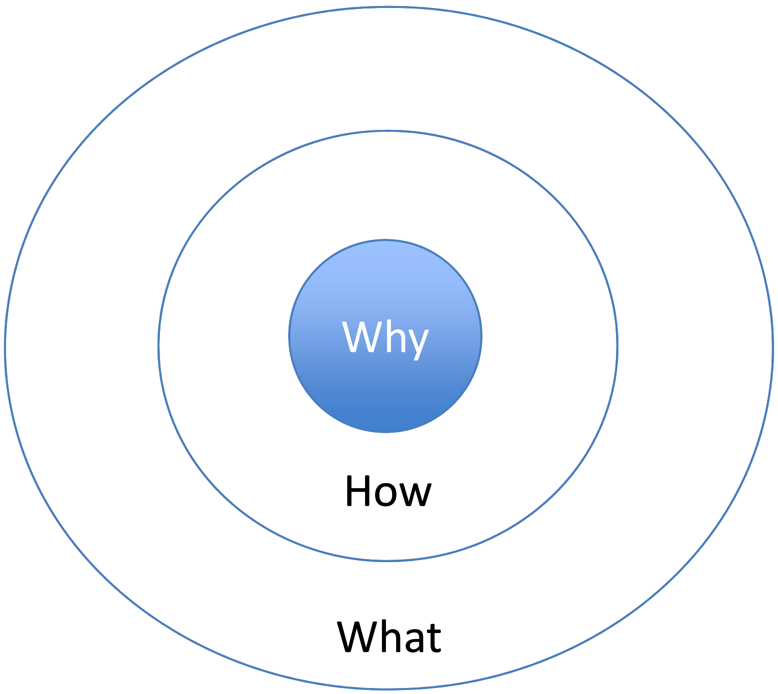
Source: Designing The Future Of Target-Date Funds, ALLIANCEBERNSTEIN Global, June 2015

What are we forgetting?



"He must have forgotten something."

Start with why?* (Not which TDF?)



Why: Help employees invest well effortlessly.

How: By taking responsibility for finding an investment vehicle that works best for most participants.

What:
(1) Profile participants.
(2) Pick the QDIA that works best for the typical participant.
(3) Select the right product based upon sound due diligence.
(4) Monitor how well the selection is working and act accordingly.

* Source: Start With Why by Simon Sinek

PPA/QDIA fiduciary obligations

- Pension Protection Act of 2006 objective: Protect pension and retirement plan participants and promote saving for retirement
- Duty of loyalty: Serve participants’ best interests
- Duty of care: Exercise prudence
  – Diversify unless it is clearly prudent not to do so
  – Conduct due diligence
- Consider all three types of QDIAs
  – Target date funds
  – Managed accounts
  – Target risk (“balanced”) funds

Why would someone want a TDF?

- Focused on stable income at retirement; may annuitize
- Reasonably expects to achieve retirement accumulation and income objectives
- Average health and family history profile; average longevity risk
- Seeks to minimize investment risk at target retirement date
- Company attributes
  - Low employee turnover
  - Workforce may have above average compensation
  - Promotes retirement savings through plan design and features (auto-enrollment, high match, etc.)
  - Provides participant education and/or advice
- Let’s call this a “liquidity” profile

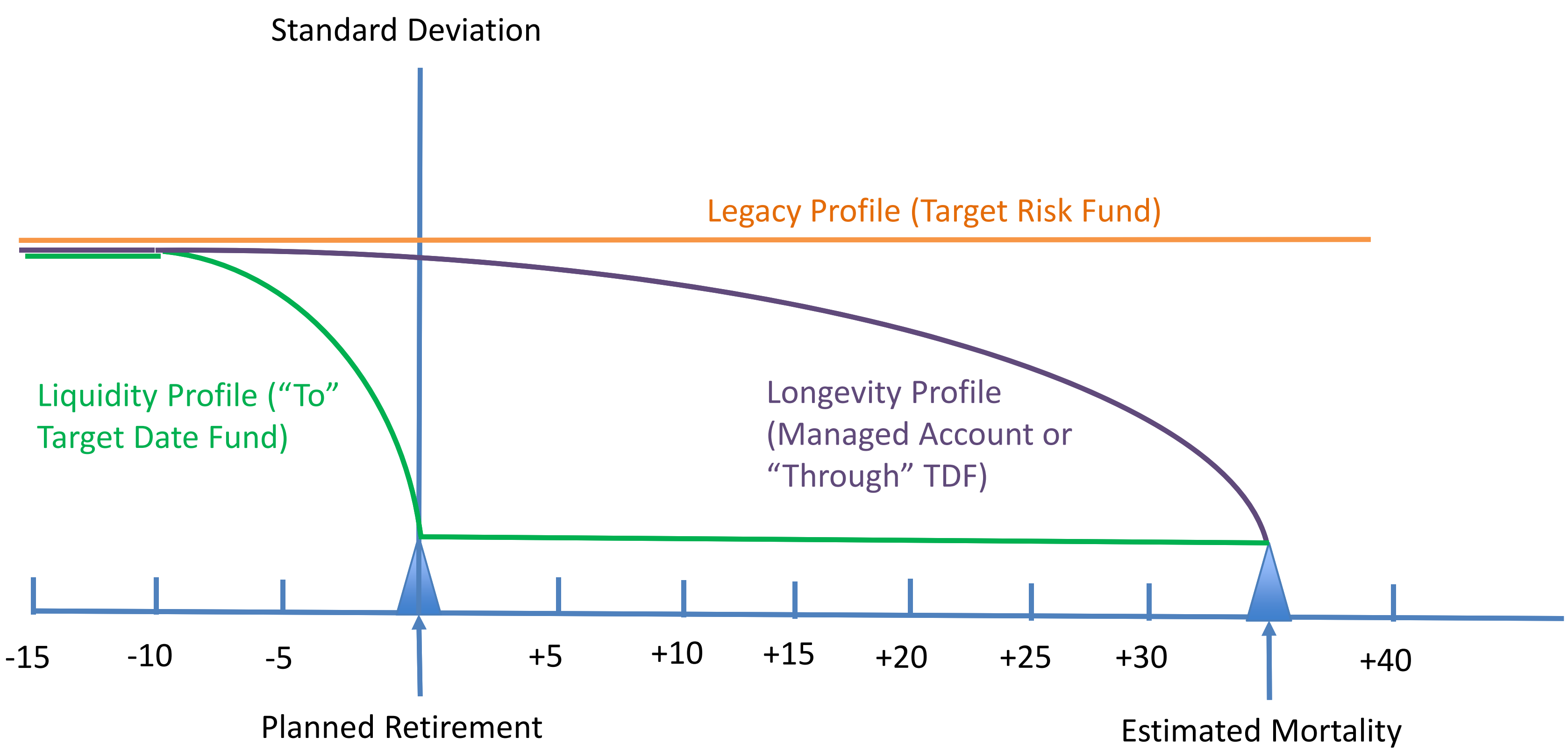
Why would someone want a managed account?

- Not confident of having sufficient income at retirement; uncertain as to when they will be able to retire
- Relatively more concerned with longevity risk than investment risk; needs to take investment risk during and after retirement
- Company attributes
  - Low employee turnover
  - Promotes retirement savings through plan design and features (auto-enrollment, match, etc.)
  - Provides participant education and/or advice
  - Workforce is generally not highly compensated
- Let's call this a "longevity" profile

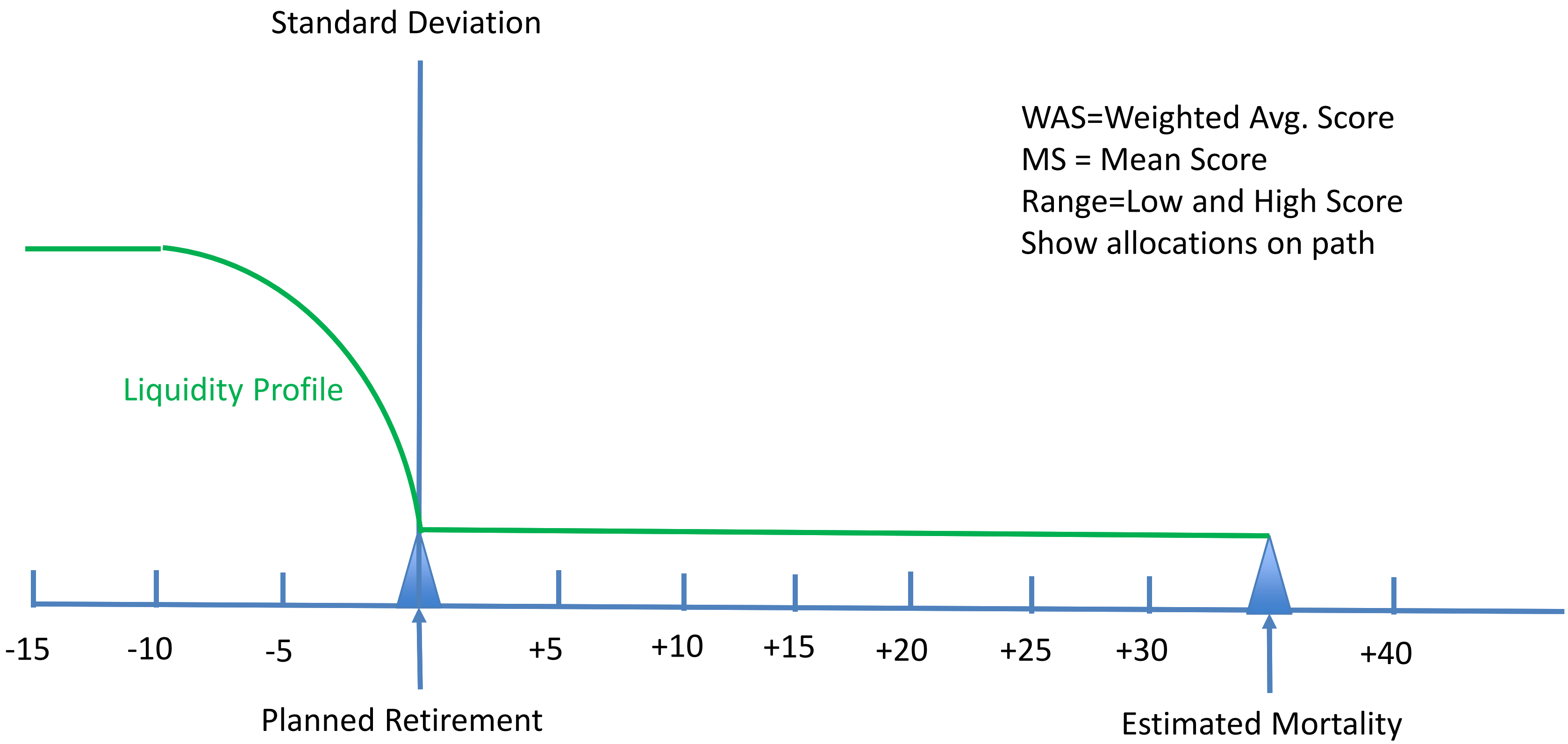
Why would someone want a target risk (balanced or multi-asset) fund?

- Seeks maximum return consistent with investment risk tolerance; longevity risk is not a key concern
- Risk capacity is likely to be high
  - Young, career-mobile, unlikely to stay with the employer to retirement
  - Older but not dependent on plan investments for retirement income
  - Highly compensated
- Company attributes
  - Above average employee turnover
  - Promotes retirement savings and provides periodic education and/or notices about reviewing investment options
  - Highly compensated, educated, and entrepreneurial workforce
- Let's call this a "legacy" profile

Glide Path Profiles



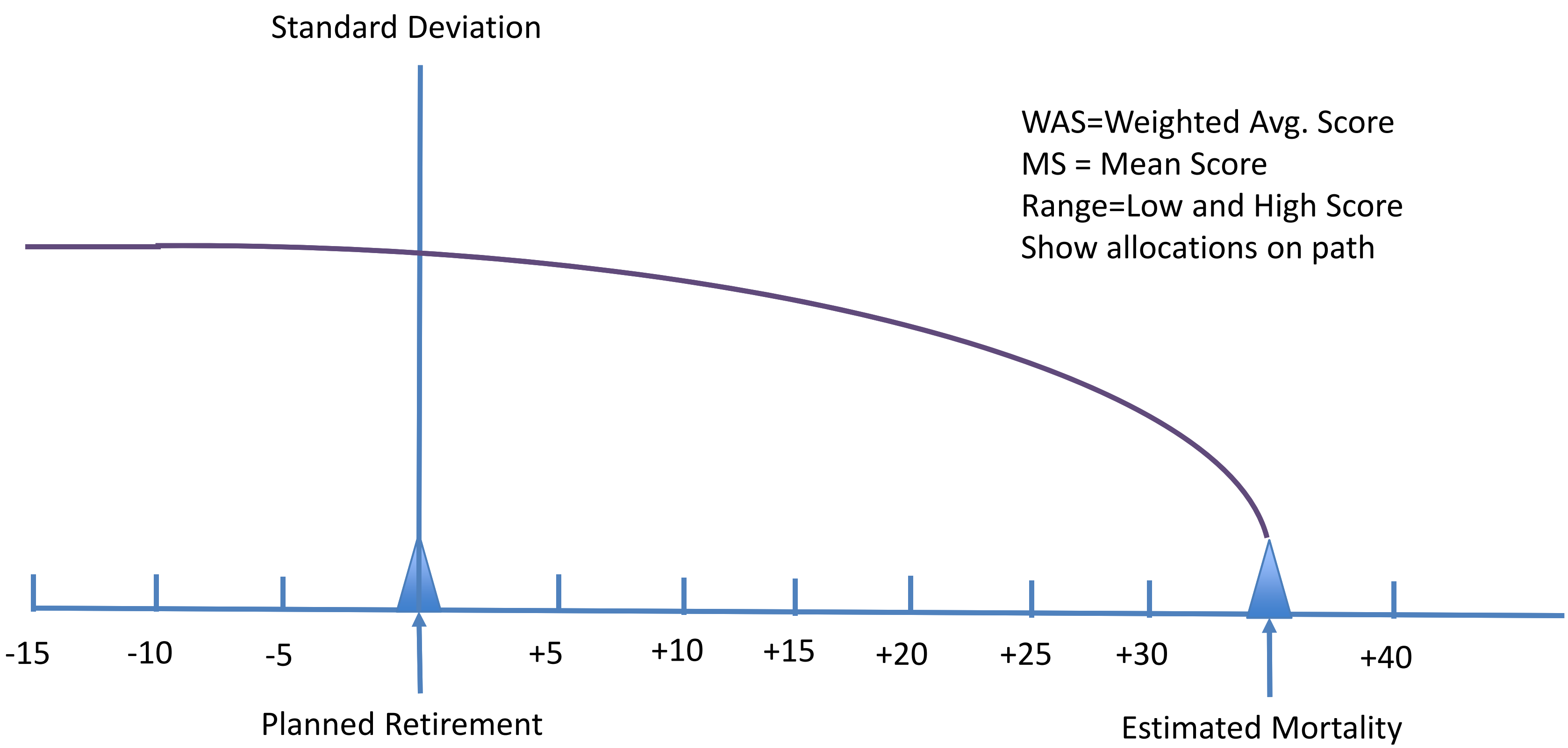
Compare “To” Target Date Funds



WAS=Weighted Avg. Score
MS = Mean Score
Range=Low and High Score
Show allocations on path

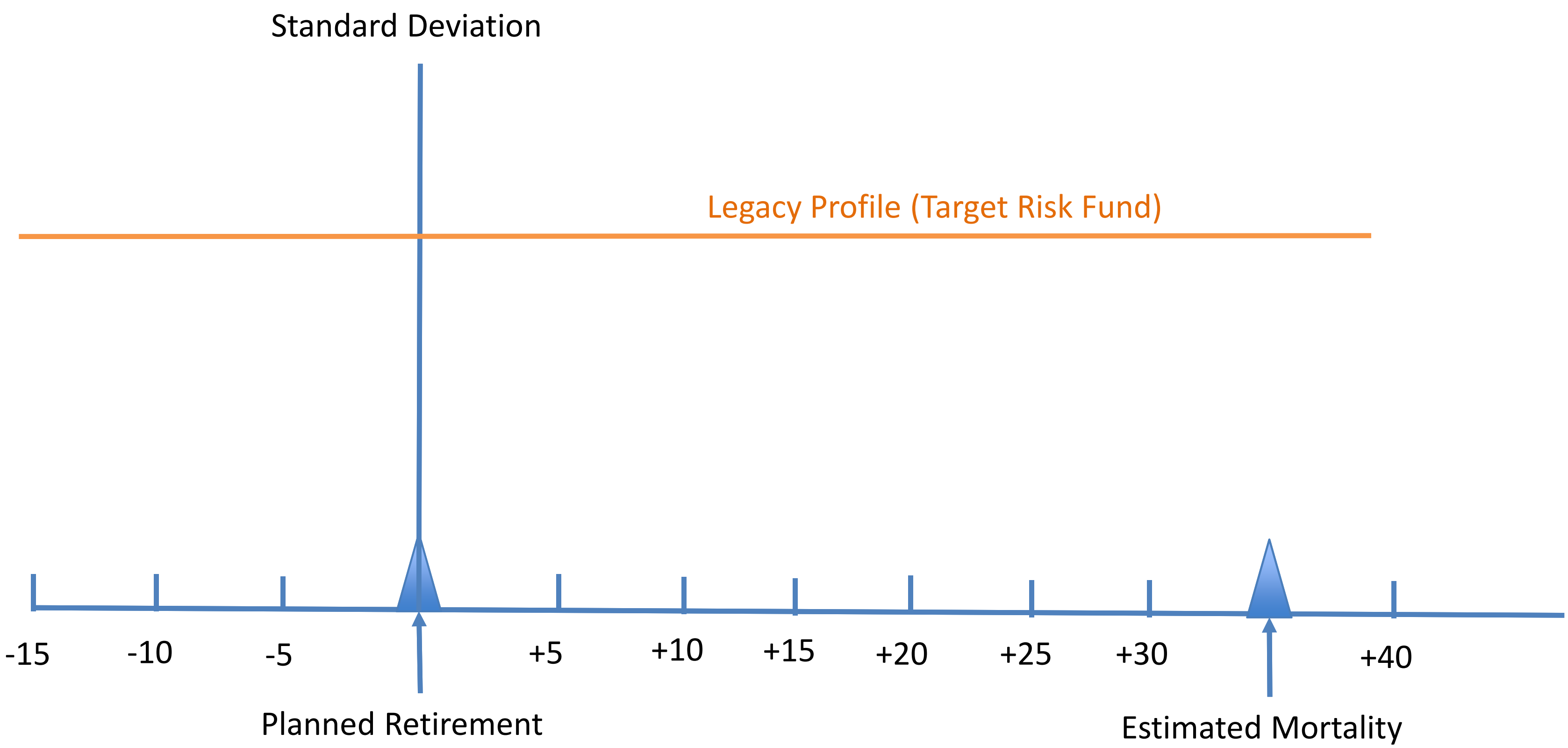
WAS										
MS (%)										
Range										
SD (%)										
Std. Dev. Slope & Percentile			Std. Dev. Slope & Percentile							

Compare Managed Accounts



WAS										
MS (%)										
Range										
SD (%)										
Std. Dev. Slope & Percentile		Std. Dev. Slope & Percentile								

Compare Target Risk Funds: Use Standard Fund Due Diligence



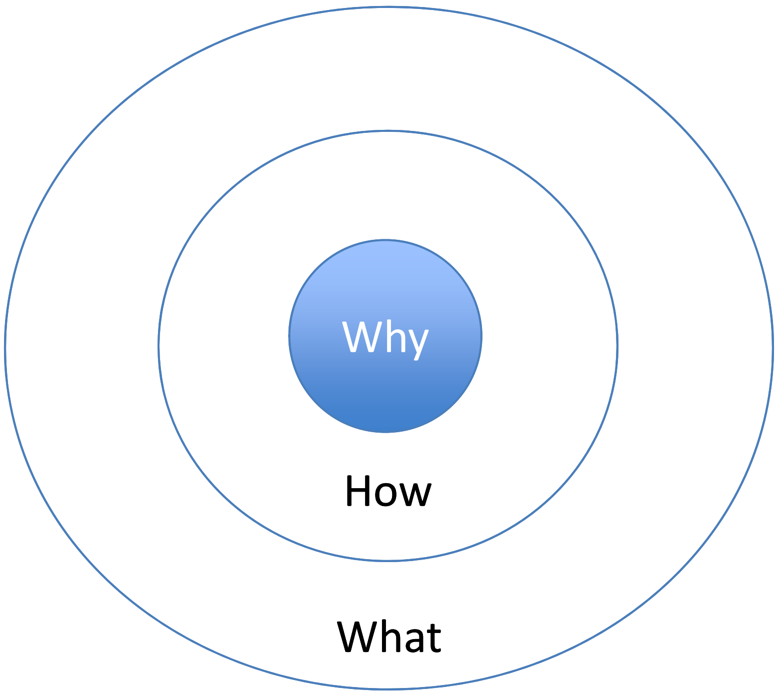
Key observations

- Diversification is required to manage risk and provide some level of growth potential (equities, fixed income, cash)
- Greater diversification is generally better; products are evolving to include more asset classes
- “Percent allocated to equity” is a poor measure of volatility; portfolio standard deviation is a better measure of total risk
- Risk-adjusted return measures are important, within context
- Four step process (versus “every plan should have a QDIA”)
  - Formulate a participant profile
  - Select the appropriate QDIA type to best serve the typical participant
  - Conduct due diligence on underlying investments
  - Monitor the QDIA and underlying investments
- Regulatory disclosure requirements and scrutiny are increasing

What would promote prudence?

- Educate
  - White paper on asset allocation/fee benchmarking and TDFs
  - Continuing education modules for in-depth issues
- Evaluate
  - Client Profile Questionnaire (individuals or participant pool)
  - Characterize TDFs by Profile (Liquidity, Longevity, Legacy)
  - Compare TDFs in given Profile
- Select and Document
  - Two step process
    - Choose a QDIA type (Balanced Fund, Managed Account, Target Date)
    - Select investments from within appropriate type
  - Substantiate decision made by recording process on-the-fly

Fi360's Golden Circle



Why: Help clients gather, grow, and protect investor assets through better investment and business decision-making.

How: Embed best professional practices that conform to the fiduciary standard in every product and service we offer.

What: Educate, equip, and enable professional advisors by providing:
(1) Investment fiduciary professional designations and continuing education.
(2) Web-based tools to manage investments to a fiduciary standard.
(3) Research, training, and support on best business practices.
(4) Certification of conformity to fiduciary standards.

Questions?

Additional information on fiduciary trends can be found at

fi360 Fiduciary Talk Podcast

www.fi360.com/fiduciarytalk

Also available on iTunes

and

fi360 Blog

www.fi360.com/blog

Questions about CE can be directed to support@fi360.com