CUSTOM TARGET RETIREMENT DATE STRATEGIES

BETTER IN THEORY THAN IN PRACTICE?

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Executive Summary

Target retirement date (TRD) funds are far and away the most popular form of qualified default investment alternative (QDIA) for U.S. defined contribution plans, likely making the selection of a plan's TRD solution the most important investment decision a plan fiduciary will make on behalf of plan participants.

While the industry has brought to market several highly competitive "off-the-shelf" TRD solutions, a 2013 U.S. Department of Labor bulletin suggested plan sponsors take their evaluation a step further, analyzing the suitability of "custom or non-proprietary target date funds." Purveyors of custom solutions often equate greater flexibility with the ability to achieve higher returns, lower volatility, or a combination of the two.

While not an impossible task, our findings suggest the benefits of these custom solutions have been systematically overstated, often by advisors seeking expanded profits or by asset managers without an off-the-shelf TRD product seeking assets to manage.

In this paper, we discuss flaws in the "custom is always better" argument as well as six critical "next steps" to take if your Committee has already implemented a custom TRD strategy.

Introduction:
QDIA Selection is a Critical Choice for Plan Sponsors

Over the past 15-years, employer-sponsored retirement plans have played a key role in addressing America's prevailing "retirement crisis." To foster healthy savings habits, plan sponsors have widely adopted plan design features such as automatic enrollment and automatic escalation. The result of both higher participation and deferral rates into qualified plans without a proactive investment election by participants has aggressively pushed capital toward plan sponsor elected qualified default investment alternatives (QDIAs). Since the passage of the Pension Protection Act in 2006, target retirement date (TRD) funds have dominated the role of QDIA across plans of all sizes (Callan Institute, 2020).

When combining higher rates of participation, higher deferral rates, and an overwhelming increase in the utilization of target retirement date funds, one thing becomes evident: There is likely no bigger investment decision a plan sponsor will make on behalf of plan participations than the selection of the plan's TRD solution.

This realization has made target retirement date funds an area of extreme focus for the asset management industry. Morningstar's peer group data tracks nearly 60 unique "off-the-shelf" mutual fund target date strategies, providing plan sponsors a wide array of strategies to consider. However, the U.S. Department of Labor broadened the TRD decision even further in a 2013 bulletin suggesting that plan sponsors also consider "custom or non-proprietary target date funds" (U.S. Department of Labor, 2013). As it stands today, nearly 1 in 5 large plan sponsors have adopted a more tailored solution, selecting a custom strategy built with their participant base in mind (Callan).

While there are certainly instances where the added flexibility of a custom TRD solution could enhance participant outcomes, our research suggests that the benefits of these custom solutions have been systematically overstated, often by advisors or asset managers seeking expanded profits.

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Purveyors of custom solutions often cite four key reasons plan sponsors should pursue customization (Callan):

1. **Control over the strategic glidepath**
2. **The ability to pursue "best in class" asset managers**
3. **The ability to select/deselect underlying managers**
4. **The potential for a more favorable cost structure**

In this paper, we discuss these proposed benefits independently, considering the oft ignored challenges they present. We make the case that when considering a complete picture of both the risk and reward of adopting a custom strategy, most plan sponsors would be best served electing an off-the-shelf solution.

For plans that have already adopted a custom TRD strategy, we also discuss techniques for measuring their performance to determine if the strategy passes ERISA's prudent person test for cost and performance.

Glidepath Control

The strategic glidepath of a target retirement date strategy, which dictates the high-level asset allocation of each vintage, typically accounts for the majority of the suite's long-term performance, both in absolute terms and relative to market benchmarks. Having the right strategic glidepath is absolutely critical to the success of a TRD manager, so it stands to reason that adding information regarding individual plan demographics could improve glidepath design. However, we would argue the vast majority of plan sponsors have demographics that reasonably resemble the national averages upon which many off-the-shelf TRD strategies are constructed. For instance, in 2019 the U.S. Bureau of Labor Statistics cited the median age of the total U.S. workforce at 42 years old (U.S. Bureau of Labor Statistics, 2019). Across our client base, the average age is 45 years old, with nearly 70% of our clients falling within 3 years of that average. Similar trends hold for expected retirement age and long-term wage growth.

Another consideration when it comes to glidepath customization is the ability for a plan sponsor to express unconventional views on capital markets or include strategic allocations to non-traditional asset classes, such as real estate, hedge funds, and commodities. While results vary over time, this flexibility has not generally enhanced returns in recent periods, with each of these investment categories lagging the S&P 500 Index by at least 3.00% annually over the past 10-years (Exhibit 1). In addition, several

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Exhibit 1: Glidepath Customization

10 Year Average Annual Return	
S&P 500 Index	13.74%
NCREIF Fund ODCE (Direct Real Estate)	10.27%
HFRX Global Hedge Fund Index	1.08%
S&P Goldman Sachs Commodity Index	-8.84%

Source: Informa StyleAdvisor. Data as of September 30, 2020.

non-traditional asset classes lack daily liquidity, potentially creating issues if a plan sponsor should choose to alter asset allocation or terminate an investment manager following a period of relative underperformance.

We are generally skeptical that glidepath customization adds value over the long-term, but there are certain situations that stand as clear exceptions. The most notable exception is the presence of an active defined benefit plan. The guaranteed retirement income provided by an active DB plan can meaningfully alter the assumptions baked into an off-the-shelf glidepath, increasing a participant's ability to take risk, but decreasing the need for them to do so in order to meet wage replacement goals while in retirement.

Open Architecture Manager Selection

An ongoing criticism of many off-the-shelf target retirement date suites is the exclusive use of proprietary investment strategies as the building blocks with which the strategic glidepath is implemented. Most plan sponsors view the construction of their core investment menu as an exercise in specialization, utilizing equity-focused asset managers such as Capital Group, Dodge & Cox, and T. Rowe Price to handle equity mandates and fixed-income powerhouses such as Baird, DoubleLine, MetWest, and PIMCO to manage bond funds. Why not apply this same logic to the construction of your TRD?

For this process to bear fruit, you need a higher proportion of your hand-selected underlying managers outpacing their respective benchmarks than what could be generated by an off-the-shelf provider. For context, three of the most widely utilized active off-the-shelf TRD suites are American Funds Target Date Retirement, Fidelity Freedom, and T. Rowe Price Retirement. Through September 30, 2020, at least 40% of the underlying managers included in these suites outpaced an appropriate market benchmark over the preceding 5-years. If selecting from the broad universe of active managers over that same time frame, eclipsing 40% has been a daunting task. In each of the four major traditional equity asset classes, less than 40% of managers tracked by Lipper have outpaced their relevant market index, with that percentage below 20% for actively managed U.S. large-cap, U.S. small-cap, and international developed large-cap funds (Exhibit 2).

Exhibit 2: Active Manager Performance

Percentage of Active Managers Outperforming Market Index (5-Years Ended 9/30/20)	
Intermediate Bond	49.96%
U.S. Large-Cap Core	16.75%
U.S. Small-Cap Core	12.15%
Foreign Developed	9.52%
Emerging Market	38.65%

Source: Lipper

Flexibility to Alter Underlying Managers Over Time

Plan sponsors offering custom target date strategies not only want the ability to specialize across their underlying managers, but also the freedom to proactively select and deselect those managers over the course of time (Callan).

Adding value through manager selection is an arduous, research-intensive process when done in isolation, and the process grows even more complex when done within the context of a mixed-asset portfolio. The managers you choose no longer operate in isolation, but rather interact with the portfolio's other assets. This injects the need to understand and account for cross-correlation, style-purity, and potential overlap between managers. Most large TRD managers have dedicated substantial resources to this task, both through investment in technology and personnel.

While there is a certain amount of comfort in retaining this control, plan fiduciaries are duty-bound under ERISA to carry out this process with the care, skill, and prudence of an expert. Plan sponsors need to make an honest assessment if they have the expertise and bandwidth internally to be consistent and cost effective in this role.

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More Favorable Costs

While available for consideration across most plan sizes, custom target retirement strategies are far more prevalent among large plans. There are several factors that contribute to this trend, but among the most impactful is a belief large plans can leverage their scale when negotiating fees. Do these plan sponsors carry enough leverage to overcome the additional costs of implementation that exist when building a customized solution?

Target retirement date customization is often implemented on a partial basis, with plan sponsors and their advisors partnering with an asset manager to tweak an element of the manager's off-the-shelf solution rather than building a customized suite from the ground up. In most cases, customization of an asset manager's glidepath, without any alteration in the underlying managers, results in additional work and a fee higher than the off-the-shelf solution. Not only that, but most asset managers have conducted significant due diligence to make their off-the-shelf product a reflection of their "best ideas." Any departure from the standard structure would likely be viewed as suboptimal in a manager's eyes.

For fully customized strategies, an advisor or consultant typically plays an integral role in development, management, and ongoing monitoring, services that open the door for higher ongoing advisory fees and potential conflicts of interest when self-monitoring performance. This potential conflict of interest is present whether the advisory partner serves in an ERISA 3(21) or ERISA 3(38) fiduciary capacity.

One way for large plans to reduce investment management costs is by utilizing institutionally priced collective investment trusts (CITs). By allocating to CITs among a custom suite's underlying funds, the plan could receive more favorable pricing than what is available in retail oriented TRD mutual fund suites. This benefit has eroded meaningfully over the past 5-years, as falling investment minimums have made CITs available to a much broader subset of retirement plans. Growing availability of CITs has prompted most off-the-shelf providers to launch their off-the-shelf suites in CIT format, affording plan sponsors access to highly competitive pricing with lower minimum allocations. Most TRD collectives have fee breakpoints based on assets to reduce cost for their largest clients, pushing pricing on widely utilized passive suites as low as 0.05%. Fee compression in CITs has also pressured pricing for smaller plans utilizing mutual fund suites, where institutionally priced share classes without a minimum investment now exist across most providers.

> ***Do these plan sponsors carry enough leverage to overcome the additional costs of implementation that exist when building a customized solution?***

Even before accounting for the labor cost of internal resources, customization no longer provides the path to the most competitive fee structure in the target retirement marketplace. It is highly likely intense competition among off-the-shelf providers will beget further fee compression going forward.

Conclusion:
Off-the-Shelf Strategies Provide the Most Likely Path to Success for Most Plan Sponsors

The nature of TRD customization makes it virtually impossible to judge the broad effectiveness of the practice relative to simply selecting an off-the-shelf provider. Not all customized solutions are built with return-maximization in mind, a fact particularly relevant for plan sponsors seeking to create a more conservative strategic glidepath than is common in off-the-shelf strategies.

That said, our experience suggests many plan sponsors, and their advisors, pursue customization based on the allure of long-term outperformance. While not impossible to outpace the industry's largest off-the-shelf providers, it is important to recognize the very high bar they have set. Over the past 10-years, 4 of the 5 largest off-the-shelf target retirement suites have outperformed the S&P Target Date Index series, with both American Funds and T. Rowe Price doing so by a significant margin (Exhibit 3). Collectively, these organizations have placed the success of their TRD strategies as a top priority, continuously expanding dedicated resources.

We concede that custom target retirement date funds can be a powerful tool for plan sponsors with truly unique circumstances or highly unconventional market expectations. That said, we believe the vast majority of retirement plans have demographics that reasonably fit the assumptions of off-the-shelf providers, and most fiduciaries lack the necessary time and/or expertise to meet ERISA standards of prudency when designing, implementing, and monitoring a customized strategy over the course of time.

The asset management industry has answered the call when it comes to creating well-researched and well-executed target retirement date solutions; most plan sponsors would be best served handing over the reins of their QDIA to the professionals.

Exhibit 3: Off-the-Shelf Target Retirement Suite Performance

	10-Years Ended 9/30/20			
Vintage	2020	2030	2040	2050
Vanguard Target Retirement Inv	7.81%	8.84%	9.58%	9.65%
Fidelity Freedom	7.30%	8.45%	8.98%	9.08%
T. Rowe Price Retirement	8.29%	9.47%	10.10%	10.15%
American Funds Target Date Retirement R6	7.99%	9.84%	10.56%	10.71%
JPMorgan SmartRetirement R6	7.13%	8.33%	8.98%	9.08%
S&P Target Date Index	*7.20%*	*8.18%*	*8.85%*	*9.18%*

Source: Informa StyleAdvisor

Appropriate Oversight of a Customized TRD Strategy

If you represent a plan sponsor currently offering a customized target retirement date solution, it is critical that you approach the ongoing management and oversight of the strategy with the same standard of care required under ERISA for externally managed strategies. Plan sponsors should take the following steps to strive for compliance:

ESTABLISH	Develop and adopt a written investment policy statement for the custom strategy, outlining management responsibilities, risk and return objectives, asset allocation guidelines, and appropriate procedures for benchmarking performance and cost.
MONITOR	At least quarterly, monitor the effectiveness of the strategy in meeting its stated goals at all levels of decision-making: strategic glidepath implementation, tactical asset allocation, and investment manager selection. If the plan sponsor or its advisor is responsible for this decision-making, an independent evaluation of performance should be obtained periodically.
BENCHMARK	Benchmark fees of the custom strategy to those of comparable off-the-shelf products, accounting for administrative fees, investment management fees, and any fees paid to internal staff or third-party advisors.
REASSESS	Periodically, at least every five years, reassess the demographics of the plan, ensuring the custom strategy still aligns with the needs of the average plan participant.
COMMUNICATE	Ensure plan participants have access to adequate and timely information regarding the strategy, including up-to-date fees, performance, and high-level asset allocation.
DOCUMENT	Formally document the implementation of the strategy, focusing on the criteria established in its investment policy statement.

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