

Fiduciary Guidebook for Target Date Funds

Prepared by the Wagner Law Group

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All investments involve risk, including possible loss of principal. You may have a gain or loss at retirement.

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This guidebook highlights certain investment features and other factors which may be considered by plan sponsors and other fiduciaries in evaluating target date funds. The definitive factors which should be considered in a fiduciary review of target date funds have not been specifically addressed in regulatory or interpretive guidance as of the publication date of this guidebook. Future legislative or regulatory developments may significantly impact target date funds and provide more definitive guidance as to how such funds are to be evaluated. Please be sure to consult with your own legal counsel concerning such future developments.

Executive summary

Target date funds (TDFs), like many investment vehicles, were adversely affected by the market's high level of volatility in 2008. In many cases, the impact on fund performance was far greater than what investors had expected, and as a result many of the underlying assumptions relating to this fund category were called into question by political leaders, media commentators and financial analysts.

The recent debate concerning TDFs is highly relevant to 401(k) plan sponsors, who have a fiduciary duty under ERISA to ensure their plans' funds (including any TDFs) are prudent investment choices for plan participants. Under this federal law, any decision to make a particular TDF series available to plan participants is subject to the duty of prudence under ERISA, a fiduciary duty that is procedural in nature.

To discharge this duty, the plan sponsor should conduct an independent investigation of the merits of its particular TDF series, giving appropriate consideration to the relevant investment characteristics and features of the series and its component funds. Key concerns to consider may include:

- **“Glide path” and underlying funds:** In light of the typical “fund of funds” structure of TDFs, plan sponsors should consider giving special consideration to the TDF series' glide path and its underlying funds. (For more information on these topics, see pages 5 and 6.)
- **Timing of reviews:** In general, fiduciary reviews should be conducted before the initial selection of a TDF series for the plan, and also on an ongoing basis at reasonable intervals.
- **Need for qualified assistance:** If the plan sponsor does not have the necessary expertise to conduct this review alone, the sponsor should seek the assistance of a qualified financial advisor or other investment professional.
- **Changes in fund selection:** If a plan sponsor does not wish to approve the use of a particular TDF series, it can be replaced with another TDF series or a different type of balanced fund. If the particular TDF series is bundled with administrative services, the TDF option could also be removed (without being replaced) or, as a last resort, another administrative service provider could be selected.

Many 401(k) Plan Sponsors have approved the use of TDFs

TDFs are a special type of balanced fund which invests in a mix of asset classes, automatically shifting to a more conservative asset mix as a stated target date approaches in accordance with a pre-determined “glide path.” Thanks to the appeal of this automatic asset allocation feature, TDFs have become a widely used investment option for 401(k) plans and participants.

Much of their popularity is attributable to the Pension Protection Act of 2006, which encouraged 401(k) plan sponsors to enroll participants automatically and to allocate their investments to a default option. In 2007, the U.S. Department of Labor (DOL) approved the use of TDFs as a “Qualified Default Investment Alternative” (QDIA). Roughly 87% of 401(k) plans with automatic enrollment features currently use TDFs as their default investment.¹ The total investment in TDFs has swelled to over \$270 billion.² Many 401(k) plan sponsors have already added TDFs to their plan menus, and others are strongly considering them for their plans.

¹ U.S. Government Accountability Office, Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, But Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges, GAO-10-31, October 2009.

² Based on SEC staff analysis of data for registered target date funds as of March 31, 2010, as cited in SEC's proposing release, entitled “Investment Company Advertising: Target Date Retirement Funds Names and Marketing,” Release Nos. 33-9126, 34-62300, IC-29301; File No. S7-12-10 (June 16, 2010.)

Recent debate over TDFs may call for special attention from plan sponsors, given their fiduciary duties under ERISA

Despite their enormous popularity, TDFs were broadly criticized as a result of their poor performance amid the market volatility of 2008, especially those TDFs with near-term target dates. For example, TDFs with a 2010 target date experienced losses that were as large as -41% during 2008 while maintaining equity exposures as high as 68%.³ Due to the “disconnect” between the conservative expectations of many people who held these funds (particularly retirees and individuals about to retire) and the unforeseen volatility of many TDFs, this entire category of funds came under heavy fire from many in Washington, the media, and the financial community.

Regrettably, employers who approved the use of TDFs for their 401(k) plans may find themselves caught in the cross-fire. The public debate over these funds raises fiduciary concerns for plan sponsors generally, who have a fiduciary duty to ensure the plan’s investment funds, including any TDFs, have been selected in accordance with the high standards of care under ERISA, including the duty of prudence. If a plan sponsor approves the use of a particular TDF series in a manner that violates these high standards of care, the plan sponsor could be held accountable for losses incurred by participants as a result of their investment in the TDFs.⁴

Plan Sponsors have a duty to investigate the merits of their TDFs

Plan sponsors and other fiduciaries are generally charged with carrying out their duties prudently and solely in the interest of participants, and they are required to make good any losses that result from a breach of their duties.⁵ The cornerstone of the various fiduciary duties imposed on plan sponsors is the duty of prudence under Section 404 of ERISA. This duty requires a fiduciary to act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”⁶

With respect to investments, this duty requires plan fiduciaries to conduct **an independent investigation of the merits of the particular investment**.⁷ This duty is procedural in nature, and the test of prudence is an examination of the fiduciary’s process for arriving at its investment decision.⁸ It is not a hindsight evaluation of the investment based solely on its performance.

Additionally, in considering any investment course of action, a plan sponsor must give **“appropriate consideration” to those “facts and circumstances” that the fiduciary should know are “relevant” to the particular investment involved, including the role the investment plays in the plan’s investment portfolio**.⁹ For purposes of this rule, the plan sponsor must make a determination that the particular investment is reasonably designed, as part of the plan’s portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain.

³ Summary of Committee Research prepared by the Majority Staff of the U.S. Senate Special Committee on Aging, Target Date Retirement Funds: Lack of Clarity Among Structures and Fees Raises Concerns, October 2009.

⁴ ERISA Section 409.

⁵ ERISA Sections 403, 404 and 409.

⁶ Section 404(a)(1)(B) of ERISA.

⁷ See, e.g., *Donovan v. Cunningham*, 716 F.2d. 1455 (5th Cir. 1983), cert. denied, 469 U.S. 1072 (1984).

⁸ See also, e.g., *In re Unisys Savings Plan Litigation*, 74 F.3d. 420 (3d Cir.) cert. denied, 519 U.S. 810 (1996).

⁹ 29 C.F.R. 2550.404a-1(b)(1).

Thus, when a 401(k) plan sponsor is considering the addition, or the continued use, of a TDF series for the plan's investment menu, it should conduct an independent investigation of the merits of the particular TDF series. It should also give appropriate consideration to those facts and circumstances that it knows to be relevant to the TDF series, including the role that the TDF option is intended to play in the 401(k) plan. When making this assessment, plan sponsors should bear in mind that the role of a TDF series in a 401(k) plan's investment menu is fundamentally different from that of other menu options in two key respects.

- First, a participant may reasonably be expected to invest his or her entire account balance under the plan exclusively in a single TDF. Typically, the automatic asset allocation feature of a TDF is premised on the assumption that the participant will not be making one-off investments in other funds.
- Second, a participant may reasonably be expected to choose a specific TDF from the available TDFs in the series based, at least in part, on the participant's anticipated year of retirement.¹⁰ Thus, the TDF with the furthest retirement year is intended for the youngest investors, and the "retirement income" TDF is intended for retirees. The other TDFs in the series are intended for those who are in between the other age demographics.

When considering the initial selection or the continued use of a TDF series, the 401(k) plan sponsor should consider the risk of loss and the opportunity for gain with respect to each TDF in the series and whether each individual TDF in the series is reasonably designed to satisfy the retirement investment goals of the participants in the applicable age demographic.

"Fund of Funds" structure of TDFs presents special challenges for fiduciary reviews

Not all TDFs are built the same way. More than 45 different fund families offer their own lines or series of TDFs. Even though TDFs from different fund families may share the same "target date" year in their names, they do not necessarily share the same investment characteristics.

As a result, there is tremendous diversity in TDF performance. For example, while certain 2010 TDFs fell as much as -41% during 2008 (as discussed above), other 2010 TDFs fell as little as -3.6% during this same period with the mean investment loss for all 2010 TDFs averaging -23%.¹¹ Similarly, just as 2010 TDFs fell by widely varying degrees in 2008, many climbed at vastly different rates during the U.S. stock market's recovery in 2009 and into the first part of 2010.¹²

The investment features that distinguish one TDF series from another fund family's TDF series are wide-ranging and complex. Such complexity arises from the prevailing "fund of funds" or tiered investment structure of TDFs. Instead of investing in portfolio securities directly, a TDF typically invests in other mutual funds. As a result, an evaluation of any TDF structured as a fund-of-funds necessarily requires an understanding of the underlying funds in which the TDF invests and how the mix of investments across the portfolio of underlying funds changes over time (i.e., the glide path).¹³ Of course, in addition to considering a TDF series' glide path and its underlying funds, plan fiduciaries should also consider the qualifications of the TDF series' investment manager and all other relevant facts and circumstances.

Plan sponsors should never "turn a blind eye" to a TDF's underlying investments on the flawed assumption that the TDF's investment manager has accepted this responsibility as an ERISA fiduciary on their behalf. For ERISA purposes, the investment manager of a plan's selected TDF series is not a plan fiduciary.¹⁴ Thus, plan sponsors are alone in their ERISA fiduciary duties to evaluate all the relevant aspects of a selected TDF series, and they should consider giving special consideration to the TDF's glide path and its portfolio of underlying funds, as described below.

¹⁰ See Investor Bulletin: Target Date Retirement Funds, dated May 6, 2010, a joint release from the U.S. Department of Labor and the U.S. Securities and Exchange Commission.

¹¹ As reported by SEC Chairperson, Mary L. Schapiro, at address before the New York Financial Writers' Association Annual Awards Dinner, June 18, 2009.

¹² The one-year total return for the S&P 500 index from April 1, 2009 through March 31, 2010 was 49.77%. The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

¹³ See Investor Bulletin: Target Date Retirement Funds, dated May 6, 2010, a joint release from the U.S. Department of Labor and the U.S. Securities and Exchange Commission.

¹⁴ DOL Advisory Opinion 2009-04A issued to Avatar Associates, LLC, dated December 4, 2009.

Special considerations when reviewing the glide path of TDFs

One of the critical features of a TDF series is its glide path, which determines the current asset mix of all the TDFs in the series as well as the future asset mix of each individual TDF. Glide path information is generally available in the TDF's prospectus. When reviewing the glide path, plan fiduciaries should consider making the following inquiries:

- **Creation of the glide path.** What investment philosophy and methodology was used to create the glide path? Was any kind of stress testing or modeling used to assess how robust the glide path might be in different environments? What were the qualifications of the creators of the glide path, and do they have expertise in asset allocation analysis?
- **Equity exposure.** For each TDF in the series, identify the percentage of the fund's investments in equity. Given the applicable level of equity exposure, is each TDF's investment risk appropriate for the intended demographic of participants? It may be helpful to look at this risk from the perspective of a handful of representative participants.
- **Risk management.** Given the recent volatility of equity markets, many TDFs have revisited their overall philosophy for managing downside risk. Does the TDF series have a considered approach for addressing this risk? Special consideration should be given to near-term TDFs in the series (e.g., 2015 TDF).
- **Slope of glide path.** What is the "slope" of the TDF series' glide path? Does it reduce the level of equity exposure ratably over time, or does the equity exposure remain relatively high and then decline steeply only near the end of the glide path? Is the slope of the glide path appropriate for all phases of a participant's life cycle?
- **"To" or "through" retirement.** Since the average 65-year-old is expected to live another 21 years, many TDFs extend their glide paths "through" retirement. Some may not reach a final asset mix until 20 or 30 years after the target year. Does the TDF glide "to" or "through" retirement?¹⁵ Is the post-retirement phase of the glide path appropriate?
- **Rebalancing.** Because a TDF's underlying investments may appreciate and depreciate at varying rates, the asset mix may drift from the glide path. How far may the asset mix drift from the mix prescribed in the glide path? How and how often is rebalancing done? Does the TDF manager have an appropriate process for rebalancing?
- **Tactical asset allocation.** Does the TDF manager have the ability to make tactical changes to the asset mix that depart from the glide path? If so, are there any restrictions on this ability? Is this discretion intended to provide downside protection to investors? Does the investment manager have expertise in tactical asset allocation analysis?

¹⁵ Based on IRS Single Life Table used for determining the life expectancy of an individual for purposes of required minimum distributions. Section 1.401(a)(9)-9, Q&A-1 of Treasury Regulations.

Special considerations when reviewing the underlying funds of TDFs

Another critical feature of a TDF series structured as a fund-of-funds is its portfolio of underlying funds. Typically, the names of the underlying funds and other information can be found in the TDF's prospectus. When reviewing the underlying funds, plan fiduciaries should consider making the following inquiries:

- **Asset classes and categories.** Which asset classes and categories are represented by the various underlying funds? Do such asset classes and categories allow for appropriately diversified TDF investment portfolios?
- **Investment strategy of underlying funds.** Do you understand the investment strategy and associated risks of investing indirectly in the various underlying funds? Review their historical performance, which may be available in the TDF's prospectus.
- **Multi-manager capabilities of fund family.** Are the managers of the underlying funds affiliated with the same fund family? If so, does the fund family have the necessary capabilities to support a multi-manager, multi-asset-class investment strategy?
- **Active vs. passive management.** Are the underlying funds actively or passively managed? When a fund is actively managed, investors benefit from the expertise of its manager. A passively managed fund typically has lower operating expenses.
- **Manager-level diversification.** When multiple investment managers specialize in the same asset class but use different sources of information and investment processes, diversification can be achieved at the manager-level. Does the TDF invest in different and diverse funds in the same asset classes, resulting in manager-level diversification?
- **Fees and expenses.** In addition to paying any fees and expenses associated with the operation of the TDF itself, participants are also indirectly paying the fees and expenses of the TDF's underlying funds. In many instances, the TDF-level operating costs are relatively small in comparison to those of the underlying funds. Taking into account the indirect costs of the underlying funds, is the total cost of each TDF reasonable?
- **Problems with an underlying fund.** Is any underlying fund objectionable because of poor performance or any other reason? If so, this conclusion should not result in the automatic rejection of the entire TDF series, and the underlying fund at issue should be evaluated in its proper context. The applicable fund's role as an underlying investment for the TDFs should be weighed and considered along with all relevant facts to determine if the TDF series is a suitable and prudent investment choice for participants.

Implementing a prudent review process to evaluate the plan menu, including TDFs

Generally, in the case of 401(k) plans, the plan sponsor is responsible for the selection of investment options for the plan's menu, including any TDF option, and each participant is responsible for the allocation of his or her account balance across the plan's available investment options. Special fiduciary relief is available to 401(k) plan sponsors so that they are not held responsible for the individual allocation decisions of participants.¹⁶

Plan sponsors remain subject to ERISA's general fiduciary standards in both (1) the initial selection of any investment menu options, including TDFs, and (2) the ongoing determination that such options "remain suitable and prudent investment alternatives for the plan."¹⁷ Thus, once a TDF series and any other investment alternatives are selected for the plan, the fiduciary has an ongoing duty to monitor investments with reasonable diligence and to remove plan assets from any investment that is improper.¹⁸ This duty to monitor plan investments prudently also applies to any QDIA selected for the plan.¹⁹

It is the view of the DOL "that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring."²⁰ If a fiduciary lacks the education, experience, or skills to be able to conduct a reasonable, independent investigation and evaluation of the risks and other characteristics of the proposed investment, the fiduciary must seek independent advice.²¹ Thus, unless they possess the necessary expertise to evaluate such factors, plan fiduciaries would need to obtain the advice of a qualified expert.²²

Plan sponsors can satisfy these fiduciary requirements under ERISA with a prudent review process. This process does not need to be laborious or time-intensive, but the review should be purposeful. If the plan's investment menu includes a TDF series, the plan sponsor should consider incorporating the inquiries described in this guidebook in its fiduciary review. Reviews should be conducted on a regular basis, such as annually or at other reasonable intervals. Consistent with DOL guidance, a written record of each review should be maintained to demonstrate that the plan sponsor is conducting fiduciary reviews of the plan's investment options on an ongoing basis. If a 401(k) plan sponsor does not have the necessary investment expertise to conduct a comprehensive fiduciary review, the employer should seek the assistance of a qualified financial advisor or another investment professional.

¹⁶ Sponsors of participant-directed retirement plans, such as 401(k) plans, qualify for this special fiduciary relief by satisfying the conditions of Section 404(c) of ERISA.

¹⁷ Preamble to DOL regulations under ERISA Section 404(c), 57 Fed. Reg. 46922 (Oct. 13, 1992). On October 20, 2010, the DOL reaffirmed its longstanding view of a plan sponsor's ongoing fiduciary duties when it finalized an amendment to its regulations under ERISA Section 404(c), providing that plan sponsors remain subject to their "duty to prudently select and monitor" any investment options offered under the plan. 29 C.F.R. 2550.404c-1(d).

¹⁸ See, e.g., *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y.1998).

¹⁹ 29 C.F.R. 2550.404c-5(b)(2).

²⁰ DOL Interpretive Bulletin 94-2.

²¹ See, e.g., *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y.1998).

²² See, e.g., U.S. Department of Labor Interpretive Bulletin 95-1.

Considering changes to plan's TDF series or removal of TDF investment option

One of the advantages of performing a regular review of the plan's TDF series is that the plan sponsor can have a measure of confidence that these funds are properly satisfying the investment needs of plan participants. Another advantage is that, even if a TDF were to underperform for an unforeseen reason, the plan sponsor would not be responsible under ERISA for the corresponding losses suffered by plan participants. Of course, to enjoy this protection from fiduciary liability, the plan sponsor would need to demonstrate it had conducted an independent investigation of the merits of the TDF series and that it had properly concluded that the TDF series was a suitable and prudent investment choice based on this investigation.

If the plan sponsor is unable to reach a favorable conclusion in connection with its review of the TDF series, it must take action to remove the imprudent investment option from the plan as soon as possible. One potential approach would be to replace the applicable TDF series with another TDF series from a different fund family. This approach may be problematic if the plan's recordkeeper has "bundled" or otherwise conditioned its administrative services on the continued use of the same TDF series. A potential solution to this problem may be to replace the TDFs bundled with the recordkeeper's services with another type of balanced fund, such as a lifestyle fund, from the same fund family preferred by the recordkeeper.

In the alternative, a plan sponsor could always eliminate a TDF series from the plan's menu without replacing it with another option. Such action may be necessary in situations where the plan's recordkeeper does not allow the use of an alternative TDF series (or the use of any other type of balanced fund as a substitute investment option). If the applicable TDF series is the plan's QDIA, the permanent removal of the default investment option may also necessitate the elimination of the plan's automatic enrollment feature. As a last resort, the plan sponsor could consider switching to a different administrative service provider that does not place such onerous restrictions on the selection of TDFs or other balanced funds for the plan menu.

Conclusion

Given the unanticipated volatility exhibited by TDFs in 2008 and the criticism that this inspired, sponsors of 401(k) plans with TDF investment options should ensure that the plan's selection and continued use of its TDF series is in accordance with the high fiduciary standards of ERISA. To satisfy ERISA's duty of prudence, every plan sponsor should conduct an independent investigation of the merits of its TDF series and give appropriate consideration to the relevant investment characteristics and features of the TDFs. In light of the typical "fund of funds" structure of TDFs, plan sponsors should consider giving special consideration to the TDF series' glide path and its underlying funds. Reviews should be conducted on an ongoing basis, and if the plan sponsor does not have the necessary expertise to conduct this review alone, the plan sponsor should seek the assistance of a qualified financial advisor or another investment professional.

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