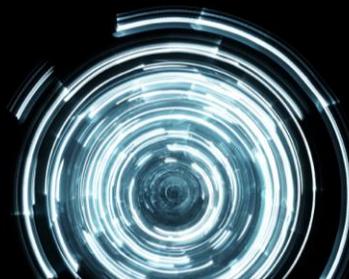


8 observations on custom target date funds



Russell Investments Research / Viewpoint



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Increasing numbers of large U.S. plan sponsors have decided that off-the-shelf target date funds aren't for them, and are finding custom target date funds more attractive – for several reasons:

- Custom funds allow for increased control of the glide path and underlying investment allocations
- Custom funds take into account materially different participant characteristics, relative to the general population
- Custom funds help meet sponsors' desire to control fees

Adding to the popularity was a fact sheet issued by the Department of Labor in 2013 ("Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries¹," which suggested that plan sponsors "inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan."

Russell Investments is in a unique position to address the subject, due to our experience as both an early implementer of both non-proprietary and custom target date funds and as a consultant to plans that use other custom target date managers. In this paper, we discuss what we've learned since first entering this arena in 2007.

Introduction

In 2008, Russell Investments published "Twelve Observations on Target Date Funds,"² an important paper for those new to how target date funds worked and for those seeking the means to evaluate which funds would be right for their defined contribution plans. Generalizing about, and deciphering the nuances of, the 40-plus off-the-shelf target date funds now in the marketplace is a monumental task. However, to help plan sponsors better understand what's going on underneath and adapt to current best thinking, we believe a few things can be said with certainty. This paper delves into the strengths, different approaches and critical factors in a customized target date approach.

Eight observations

	Glide path construction	<ol style="list-style-type: none">1. The process of evaluating participant demographics for the creation of a glide path leads to interesting findings for heterogeneous populations.2. The existence of a DB plan can be accounted for in different ways.3. There are benefits to customizing the underlying asset allocation beyond the high-level glide path
	Building block decisions	<ol style="list-style-type: none">4. Custom target date funds typically utilize a thoughtful mix of active and passive management.5. Many effective plan sponsors are selecting multi-manager structures to manage the sleeves and core line-ups that populate their custom target date funds.6. There are benefits to being dynamic in both the short term and the long term.
	Operations and ongoing monitoring	<ol style="list-style-type: none">7. The selected glide path manager will also be an operational partner. The right manager can make life easier for the plan sponsor; the wrong one can make it far more difficult.8. Performance evaluation is important and should be based on clearly stated (documented) objectives.

Before getting into specific observations, it is important to define a “glide path manager” and associated services. Services are most often differentiated by whether the glide path manager is claiming ERISA 3(21) or ERISA 3(38) status. An ERISA 3(21) investment manager usually focuses on advising the plan sponsor on asset allocation, which in turn means greater responsibility for decision-making and coordination of vendors on the part of the sponsor. An ERISA 3(38) investment manager is one who has discretionary control over the management of the target date fund solution, and thus typically has more involvement in the detailed operational aspects of implementing the custom fund. For purposes of this paper, we assume that the glide path manager is acting as an ERISA 3(38) investment manager. Though Russell Investments advocates for custom glide path solutions, we recognize that not all plans will benefit from customization. A plan’s size is a big determinant of whether a customized solution is feasible; and in cases where it is deemed feasible, size will impact the composition of the resulting glide path. For instance, if the plan does not have sufficient economies of scale, it may be limited as to the amount of dollars it is able to invest in diversifying asset classes. While our observations are relevant for a plan with a large-enough asset base to implement “best” investment ideas, for smaller plans, several of the benefits associated with custom target date solutions can be realized via other solutions.

Observations



Glide path construction

1. The process of evaluating participant demographics for the creation of a glide path leads to interesting findings for heterogeneous populations

The construction of a target date fund series, whether it is to be a custom or a generic offering, typically begins by describing a “typical participant” as representing the intended population. The glide path manager must make assumptions about salary, salary growth rate, contribution rate, contribution rate growth rate, whether there is also a defined benefit plan, projected retirement age and any other matters relevant to the typical participant. A plan sponsor customizing a target date fund based on plan demographics may quickly come to the realization that some participants fit the mold of “average” and others don’t. For example, we often see situations where some DC plan participants also have DB plans, and others don’t. We have seen situations where, in the DC plans of companies that have undergone several mergers and acquisitions over the years, savings rates and/or salary levels range widely among the subsets of participants. As a result, the glide path that best fits one group might be markedly different from the “best” glide path(s) for others. To deal with this, we have often found that the sensible approach is to design a glide path not for the average participant, but for those participants who will be most dependent on the DC plan for retirement income. As an additional step, we then test the glide path to help ensure that the solution is still a prudent decision on behalf of other distinct populations as well. As plan sponsor, you’ll want to document how the custom target date fund manager has incorporated the concerns of these different groups; to help better assure that the glide path you choose is prudent; and to monitor how well that path is working for each group.

2. The existence of a DB plan can be accounted for in different ways

When some participants in a DC plan have vested benefits in DB plans as well, there are generally two ways to treat the situation when customizing a glide path. In the first method, the present value of future DB benefits is considered part of the participants’ assets, and thus is treated like bonds. All else equal, the additional allocation to bonds leads to choosing a more aggressive target date fund, to offset the low return expectations inherent in bonds. The second approach is to have the DB plan reduce the income replacement needed from the DC plan. In this case, the glide path has a lower target income-replacement goal to try to meet, and thus may need to take less risk than if there were no DB plan. We prefer the latter approach, because we keep in mind that the DB plan is a source of future income, rather than an asset or asset class that has an expected volatility component associated with it.

3. There are benefits to customizing the underlying asset allocation, investment managers and active/passive decisions on top of the high-level glide path

In some cases, a plan sponsor might consider the employee base to be homogeneous, and will then discount the value of a custom target date fund structure, figuring that an off-the-shelf target date fund that closely meets the population’s needs can readily be found. Contrary to popular belief, it is not necessarily the customization of the glide path to fit a plan’s specific demographics that leads plan sponsors to go with a series of custom target date funds. The benefits of customization can include managing other aspects of the target date solution, such as asset classes, managers and the active/passive decision. In addition, plan sponsors can harmonize their investment beliefs across both DB and DC plans. Such an approach can benefit the plan by leveraging the existing managers’ due diligence and the potential to reduce fees (if existing managers are used).

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Building block decisions

4. Custom target date funds typically utilize a thoughtful mix of active and passive management

Custom target date funds allow plan sponsors, along with their glide path manager, to make a conscious choice as to where the best active management opportunities exist. DC plan sponsors are typically fee-conscious, but we believe decisions shouldn't rest on the absolute level of cost alone. A custom target date fund can, if desired, allow the plan sponsor to set a fee budget, and thus trade-offs can be made asset class by asset class as to where to spend that fee budget. In fact, one of the benefits of implementing a custom solution is the flexibility to select strategies based on the investment committee's belief set on active management opportunities at the asset-class level.

5. Many effective plan sponsors are selecting open-architecture, multi-manager structures to manage the sleeves and core line-ups that populate their custom target date funds

One of the recommendations in the DOL's 2013 "Target Retirement Funds – Tips for ERISA Plan Fiduciaries" fact sheet was to "Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan." For decades, Russell Investments has espoused the benefits of an open-architecture approach to investing. We have seen open architecture embraced not only by DB plans, but also by DC plans in their core (non-target date) investments. Non-proprietary and custom target date funds utilize this "best-in-class" investing approach, as opposed to the approach taken in a target date fund made up entirely of proprietary investments from a single investment organization. We also observe that many plans are using multiple managers within some asset classes. Using both an open-architecture and a multi-manager structure allows the plan sponsor to hire specialist managers, and to increase diversification. Both approaches are increasing in prominence among custom target date fund adopters and across DC plans in general.

6. There are benefits to being dynamic in both the short term and the long term

We find effective custom target date fund providers to be those that can best adapt to changing circumstances and external market events. Over time, capital markets evolve, participant behaviors change and information becomes more readily available.

Appropriately, many custom target date fund providers use long-term forecasts to come up with a strategic asset allocation. These long-term forecasts change, as do markets themselves, and participant savings behaviors and company contribution levels change over time as well. As these long-term trends play out, the strategic glide path should also evolve. An effective glide path manager has the ability to make well-considered adjustments as circumstances change.

Certain asset managers also have the ability and expertise to manage asset allocations on a short-term, tactical basis. A custom target date fund series may or may not have been operationally set up to make these adjustments, but we believe there is potential value for doing so. It is also important to make sure the manager has the tools and expertise to evaluate market forces, to mitigate risk as appropriate and to take advantage of market opportunities across asset classes. The ability to protect on the downside is especially important during times of market stress.

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Operations and ongoing monitoring

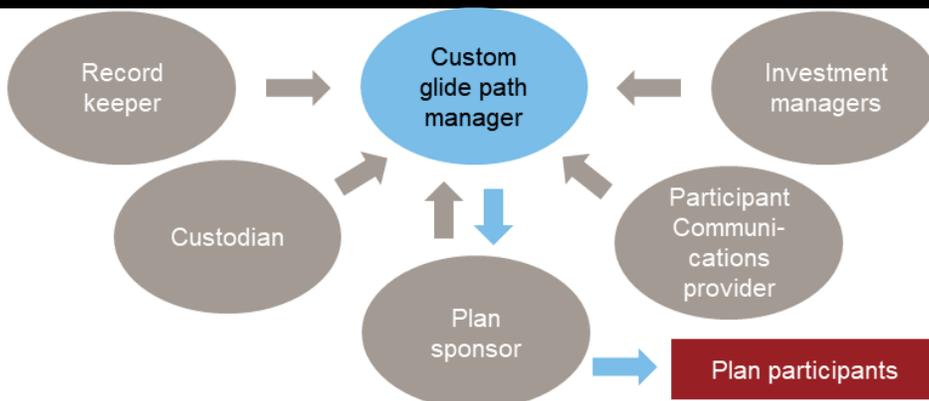
7. The selected glide path manager will also be an operational partner. The right manager can make life easier for the plan sponsor; the wrong one can make it far more difficult

Custom target date funds have numerous moving parts, including unitizing, rebalancing, cash flow allocating, to name a few. In addition to creating and managing the glide path and making asset allocation decisions, glide path managers also need to act as operational partners. A provider with experience in operational aspects, who can coordinate these moving parts – one who has encountered similar issues before, and has the skills to help manage the process leading to successful implementation of custom target date funds and their subsequent monitoring – is key.

The ideal glide path manager should act as both project manager and investment manager – that is, should be someone who knows and is skilled in the necessary tasks for effective implementation; who understands the strengths and weaknesses of each party; and who can be a conduit for the plan sponsor in getting things done. An effective partner will give the investment committee and staff confidence in the decisions being made, and make the day-to-day management of the custom funds nearly as seamless as any other fund. An inexperienced glide path manager often leaves the plan sponsor unguided through many difficult operational and investment decisions, which is one of the reasons that custom target date funds have faced criticism for their complexity. Poor execution can be costly, wiping out advantages that a custom target date would otherwise bring.

Assisting in determining cash flow management and rebalancing rules are a couple of examples of how a partner can offer expertise. The glide path manager should be able to navigate the capabilities of the record keeper and/or custodian to direct complex structures. For instance, a simplistic rebalancing strategy might consist of a tolerance band around each asset class of plus or minus 2%. A more seasoned glide path manager may realize the limitations of such a policy and suggest looking at the relative size of each asset class and tailoring the rebalancing triggers to reduce unnecessary turnover. The glide path manager might also suggest using a liquidity vehicle to handle intra-month cash flows, and to allow for the inclusion of investments that don't trade every day. An effective glide path manager will take into account these and many other variables that could potentially lead to extra costs or unnecessary tracking error.

Exhibit 1: A glide path manager's role as project manager



8. Performance evaluation is important and should be based on clearly stated objectives

One potential pitfall in the design of a custom strategy is a lack of understanding between the parties on how success will be measured. This is true of any target date fund, but custom target date funds are typically designed with a certain objective in mind. The most successful partnerships between custom target date fund managers and plan sponsors occur when a mutual understanding of investment objectives and evaluation metrics is agreed upon. Thus, we discourage placing emphasis on peer group comparisons, because peers may have different objectives. Instead, we recommend a multifaceted approach to target date fund evaluation.³

Plan sponsors should evaluate the success of a target date fund provider on the basis of the provider's ability to deliver investment performance that is tied to the objectives of the target date funds. The objectives need to align with the plan's beliefs. For example, some target date fund providers' methodologies focus on giving participants the best chance to replace a good percentage of final-year income, with a bias against falling exceedingly short; others have the objective of maximizing participants' account balances without regard for potentially large shortfalls. Whatever the objective is, the target date series should be evaluated on it, to determine the success of efforts to attain it.

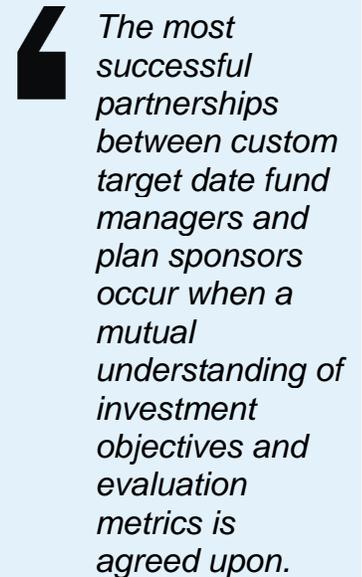
Whether a plan sponsor believes in peer-relative performance, benchmark-relative performance or a mixture of both, metrics should be specified in advance so that no surprises arise on either end. One good thing about custom target date funds is that if your performance evaluations lead you to conclude that an aspect of the solution isn't working – glide path, asset allocation decisions, underlying fund decisions, fees or implementation – changes can be made to discrete pieces. With an off-the-shelf target date fund, you need either to change the whole solution or live with the fact that there are aspects you cannot change.

Risk should be measured in terms of not meeting retirement objectives

Conventionally, investment risk is measured by some volatility calculation, like standard deviation of returns. But that point-in-time measurement of asset return volatility is meaningless in a 40-year savings program. The more important risk is falling short of your goals of meeting certain levels of income replacement at retirement. Also, it's important not to think of this risk measurement as an "all-or-nothing" proposition. Some target date funds that define risk simply as running out of money in retirement (without recognizing that there is a big difference between not meeting a goal by \$1 and not meeting it by \$1 million) tend to be much more aggressive. That's because they've defined their goal as either you met it or you didn't.

Ideally, your custom target date fund provider will provide an evaluation of risk through multiple lenses:

- **Distributional analysis:** Measures risk in terms of what most participants care about most – their account balance – by quantifying the average loss expected in dollars from extreme negative scenarios. Measures include VaR (value at risk), CVaR (conditional value at risk), in addition to standard deviation.
- **Sensitivity analysis:** Provides insight into sources of market risk exposures by modeling shocks to the portfolio (i.e. interest rates up +100 bps, equity market return down -20%).
- **Scenario analysis and stress testing:** Provides risk measurement under market conditions that deviate from prevailing, such as stressed market scenarios or outside of range of distributional measures, like repeats of historical events like the Global Financial Crisis of 2008 or the Taper Tantrum (the 2013 surge in U.S. Treasury yields).



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Conclusion: Target date funds, including custom funds, have been a tremendous innovation – but limitations exist

Target date funds have been beneficial for DC plan participants – they are age-based vehicles that reduce risk as retirement nears – but there are still limitations. As discussed above, a target date fund series is built around one “typical participant” who is deemed to be representative of an entire population. Off-the-shelf target date funds model that participant based on average characteristics of the general population. Custom target date funds can be modified to take into account specific characteristics unique to the participant base.

With technology, it is now possible to use the same glide path methodology but also provide for custom portfolios at the individual level. Instead of looking at that typical participant, a managed account program can look at each individual's situation in isolation and customize an asset allocation for each person. The allocation can also adjust for a participant's experience. Two participants who save and invest in the exact same way but were born in different years, and therefore live through different market cycles could have very different results in terms of how on track they are toward meeting their retirement-income goals. Technology can adapt a participant's allocation based on his or her specific needs and experiences over time.

Target date funds have undergone a great evolution since their creation. The first stage in this evolution was a trend away from proprietary target date funds to funds that utilize “best-of-breed” managers. From there, large plan sponsors have implemented custom target date funds, a development this paper has addressed. We believe target date funds will continue to evolve with the leveraging of technology for implementation of custom target date fund solutions for individual plan participants.

¹ U.S. Department of Labor, Employee Benefits Security Administration (February 2013). Available at: <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf>

² Cohen, J. (2008, April), “Twelve observations on target date funds.” Russell Investments Research

³ See Bare, R. and Greves, J. (2013, October), “Evaluating target date investment performance” Russell Investments Research.

For more information

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