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# Best practices for target date funds and managed accounts

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Defined contribution (DC) plans are the primary retirement planning vehicle for many American workers, and target date funds (TDFs) are often popular for DC participants who want to leave the management and monitoring of their portfolios to a professional investment manager. This article is designed to help plan sponsors who want to understand the best practices for evaluating and managing target date funds and managed accounts, in order to offer the most beneficial DC plan possible to their employees.

## ALL TARGET DATE FUNDS (TDFS) ARE NOT THE SAME

The passage of the Pension Protection Act in 2006 led to safe harbor status for four types of default investment options in defined contribution plans: target date funds, managed accounts, balanced funds, and capital preservation products. Since then, TDFs have become the dominant qualified default investment alternative (QDIA).<sup>1</sup>

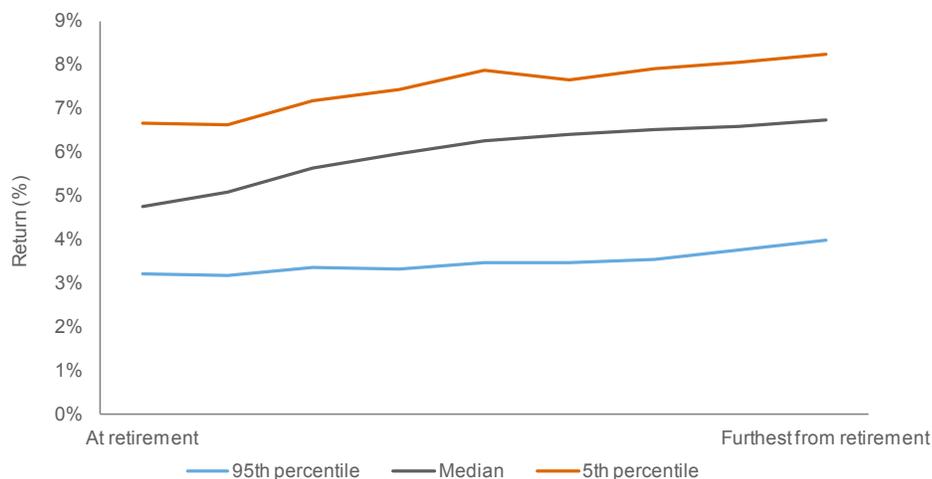
TDFs are popular for participants who want to leave the management and monitoring of their portfolios to a professional investment manager, but all TDFs are not the same. The percentage of growth assets vs. capital preservation assets changes markedly over the life of a TDF in what is known as “the glide path,” and glide paths vary widely across TDF providers.

TDFs can be designed for maximum accumulation, downside protection or income replacement in retirement. Depending on the outcome desired, the glide path may maintain a static asset allocation after retirement (remain flat) or continue to de-risk. According to Russell Investments’ analysis of 2016 data from Morningstar, the allocation of growth assets at retirement varies by 45 percentage points across TDF providers. The differences in asset allocations can lead to very different outcomes for participants.

▮ The allocation of growth assets at retirement varies by 45 percentage points across TDF providers.

<sup>1</sup> In 2015, TDFs accounted for 97% of QDIA assets. *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data*, Vanguard, 2016. Available online at [vanguard.com](http://vanguard.com).

## Exhibit 1: Distribution of Morningstar Target Date Universe returns



Source: Morningstar Direct and Russell Investments analysis. Reflects the one-year return of the Morningstar Universe as of 6/30/16. Results not adjusted for survivorship bias.

It is important for plan sponsors to understand plan participant demographics and behaviors and how they compare to glide path assumptions. If plan sponsors determine the levels of risk that make sense for participants at each life stage, then they can answer one of the most important questions about the glide path: How much equity exposure should participants have at the point of retirement?

There is also more to selecting a target date fund than just choosing a glide path. Plan sponsors should review the underlying asset classes and the investment manager's skill and track-record in each, be comfortable with target-date fund's overall objective, and assess the total costs in light of the portfolio construction and investment strategy employed.

### FOLLOW THE DOL ROAD

The Department of Labor (DOL) has provided a framework for selecting and monitoring target date funds. In February 2013, the DOL released "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries".<sup>2</sup> Chief among the suggestions

from the DOL was that fiduciaries need to understand how target date funds work, and establish a process for evaluating their fit for a specific plan. Recognizing that the target date fund universe is as varied as the American workforce, regulators made the point that non-proproprietary and custom solutions may be viable options for some plans and should be explored. The DOL suggested six steps for plan sponsors:

1. **Explore:** *Inquire* about whether a custom or non-proproprietary solution would be a better fit.
2. **Process:** *Establish* a process for comparing and selecting funds. *Document* it.
3. **Research:** *Understand* the investments and how they change over time.
4. **Calculate:** *Review* the fees and expenses.
5. **Communicate:** *Develop* effective employee communications.
6. **Manage and Monitor:** *Evaluate* the target date fund and recommendations you received.

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<sup>2</sup> Available at <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf>

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Some plan sponsors find that these responsibilities exceed their in-house capabilities, and decide to outsource certain fiduciary duties. Outsourcing can take many forms, from limited scope duties such as investment manager selection and monitoring to full plan management and administration. To evaluate providers, it helps to understand the history and perspective of the three types of firms that generally provide outsourcing services – consulting firms, investment managers, and multi-managers.

Some consulting firms have built the infrastructure and expertise required to offer new outsourcing services and products. It is important to ask consultants about their track record in outsourcing and their willingness to provide fiduciary services beyond advice. Since consultants have not traditionally focused on investment implementation, their experience and capabilities in this area cannot be taken for granted, especially the ability to rapidly adjust client portfolios in response to changing market conditions.

Investment managers have experience making investment decisions and providing investment-related services, but their focus is not necessarily on an entire portfolio. Accordingly, it is important to determine the breadth of an asset manager's experience and their willingness to customize a solution for the plan sponsor. This includes managing risk across asset classes and managing the entire portfolio towards measurable goals that matter to clients. Since plan sponsors may have relied on consultants or in-house staff for manager research, they should query investment managers about this capability. Investment managers should be able to show that their "buy list" has historically had high probability of outperforming the relevant index.

Multi-managers seek to provide small-to-medium sized plans with greater diversification and access to money managers typically available only to large plans. They generally focus on manager

selection for the overall exposures in the portfolio rather than narrow security selection within specific asset classes. As a result, it is important to ask multi-managers about their willingness to provide fiduciary services beyond manager selection oversight, and their ability to provide a broad set of investment options backed by strong manager research and consulting experience.

### AVOID FALSE CHOICES

The percentage of DC plans with a managed account option has been rising such that the majority of participants are now offered this choice.<sup>3</sup> Managed accounts are also increasingly being designated as qualified default investment alternatives (QDIAs), but many plan sponsors feel they can choose only one of the designated safe harbor categories (i.e. a TDF, balanced fund, or a managed account). On the other hand, offering just one of these QDIAs may not be optimal for workers of all ages or retirees.

Plan sponsors have another choice—the hybrid QDIA. Hybrids include an asset allocation fund, like a target date fund or balanced fund, and then transition into a professionally managed portfolio when many participants need it most—as they get closer to retirement and their financial situations may become increasingly complex. Hybrids have the potential to improve outcomes, compared to a TDF-only QDIA, because professionally managed accounts can build a more personalized and precise glide path for each participant that can be adjusted based on progress toward a retirement income goal.

Despite the potential benefits of hybrids, plan sponsors are rightfully concerned about participant behavior vis-à-vis managed accounts. By some estimates, half of participants who use a professionally managed account today do not provide the information needed to customize their portfolios.<sup>4</sup> The good news is that plan sponsors no longer have to choose between utilization and the benefits of managed accounts. New QDIAs have been developed

<sup>3</sup> In 2015, 57% of participants were being offered a managed account option, up from 38% in 2009. *How America Saves 2016: A report on Vanguard 2015 defined contribution plan data*, Vanguard, 2016. Available online at [vanguard.com](http://vanguard.com).

<sup>4</sup> Lee Barney, "Half of Managed Account Users Do Not Provide Requisite Information," *PlanAdviser*, October 14, 2016. Available at <http://www.planadviser.com/Half-of-Managed-Account-Users-Do-Not-Provide-Requisite-Information/>

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that automatically collect participant information from the recordkeeping system, so that they can provide a customized asset allocation similar to a traditional managed account, but without requiring extensive input from participants.

Managed accounts can be implemented as an “opt in” or as a default for new participants. Existing participants can also be defaulted into a managed account through re-enrollment, in order to refine their asset allocations. Just as with TDFs, sponsors who choose managed accounts for their DC plans need to make sure the investment methodology is sound and consistent with the sponsor’s investment beliefs. Examples of different philosophies are target retirement income versus mean/ variance portfolios at different risk levels.

If the managed account will be a QDIA, it should be built for that purpose, not as an opt-in. Some other important issues to cover with potential managed account providers include the following:

- › Is the provider willing to take fiduciary responsibility for the asset allocation?
- › Is the provider willing to use the full plan menu for asset allocation?
- › Will participants have a high degree of customization?
- › Are the interactive tools intuitive enough to help participants make better investment decisions?
- › Will the reporting and communications help the plan sponsor understand participants better and help target campaigns to assist participants who are behind?

### BEWARE THE RULE OF THUMB

DC plan excellence goes beyond picking investments and meeting with managers. It means following a disciplined process, creating frameworks for understanding, prioritizing the workload and communicating with participants in a way that helps them make good investment decisions. It is a lot to look after, but plan sponsors who take many small steps in the right direction can improve participants’ lives in retirement. That is an outcome worth the extra care and diligence to move a DC plan from average to excellent.

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This is an abridged version of an article “Best Practices for TDFs and Managed Accounts” which will appear in Q1 2018 of *Benefits Quarterly Magazine*.

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