Striving for consistency
Complementary approaches to target date funds and managed accounts

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Target date funds and managed accounts are complementary approaches to addressing the same problem – retirement readiness for defined contribution (DC) plan participants who want a professionally managed solution. Managed accounts replace target date funds’ broad assumptions with actual participant data, and replace the target date funds’ predetermined asset allocation with a customized one that factors in each participant’s circumstances. Increasingly, plan sponsors are including both managed accounts and target date funds in their defined contribution plans. Both solutions offer imbedded advice for “do-it-for-me” investors, and ideally there should be consistency in the way that advice is determined. However, it has been difficult for plan sponsors to establish consistency between the two solutions for a variety of reasons, including, for most, lack of choice in managed accounts providers. The problem created by the lack of consistency is that well-intentioned plan sponsors can find themselves in the uncomfortable position of having done extensive due diligence on their target date fund’s glide path, methodology, and underlying assumptions, essentially setting a precedent for asset allocation advice, only to find that their managed account provider’s approach is different in some or all of these areas. This paper outlines areas plan sponsors should be aware of as they try to establish greater consistency between the approaches taken in their target date funds and managed accounts.

An overview
Managed accounts are gaining in popularity. In recent years, plan sponsors have increasingly added managed accounts to their 401(k) plans, and today more than 35% of sponsors offer managed accounts on an opt-in basis. Managed accounts are among the few investment offerings that can play a dual role in a DC plan. The fact that managed accounts are an approved QDIA means that the approach can play the central role in a DC plan as participants’ default option, or a supporting role as an optional service. Today, less than five percent of plan sponsors offer managed accounts as their plans’ QDIA, which means that the majority of plan sponsors offering managed accounts today are offering them on an opt-in basis, in addition to their plans’ target date funds.

The process a plan sponsor fiduciary goes through in selecting a target date fund makes a statement about fiduciary views on basic target date principles. Prior to deciding on a target date fund, the plan sponsor will likely have performed extensive due diligence and vetted a certain philosophy, an investment process, a set of assumptions, the underlying asset-class investments and...
the de-risking glide path. The plan sponsor should consider all the same factors when adding a managed account provider and strive for consistency wherever possible. After all, offering both target date funds and managed accounts in a plan is essentially offering two different strategies that provide the same thing (asset allocation advice) and share the same objective (retirement readiness), and that serve the same participant base (participants seeking a professionally managed investment solution).

Because managed accounts are an extension of target date fund investing, the two approaches have more similarities than differences. Each is designed to function as the sole investment solution for retirement plan participants. Both contain embedded asset allocation advice. Both use a predefined methodology to meet a predetermined objective. Both commonly, but not exclusively, use the tools of mean variance optimization and Monte Carlo simulation to develop the asset allocation that is automatically rebalanced and adjusted over time—simply put, both use a glide path approach.

Certainly, asset allocation output could differ between the target date fund and the managed account, given that managed accounts have the benefit of additional information by which to customize, including a participant’s planned retirement age, risk preferences and other individual data. The challenge often faced by plan sponsors is that there are, commonly, other unexpected misalignments. For plans sponsors who offer both target date funds and managed accounts in their plans, we offer the following areas for consideration.

1. Methodology for generating the investment advice

Glide path methodology can be different, or even contradictory, between target date funds and managed accounts, due to the range of philosophies, measures of risk, and objectives, that underpin the construction of target date funds and managed accounts. First, there can be inconsistencies between the critical assumption at the center of the target date fund and the managed account—it’s objective, its goal. Different target date funds have different objectives: income replacement; wealth accumulation to address longevity considerations; and minimization of drawdowns. But increasingly, target date funds are being managed with the income-replacement goal in mind. Likewise, managed account providers will have different stated objectives. While some are seeking to meet an income-replacement goal, most state their objective in terms of investing within a specific risk tolerance. For those managed account providers who do have a stated income-replacement goal, this goal can also differ between the plan’s target date fund and managed account offerings. For example, the plan’s target date fund may have an income-replacement goal of 80% of the participant’s ending salary, including social security, while the managed account could have a different goal—say, 100%, or 70%. Ideally, plan sponsors would determine the desired income-replacement goal for their workforce, and then select the target date fund and managed account service provider with that goal in mind.

Second, there can be inconsistencies in the de-risking of the asset allocations developed for participants nearing retirement. Seven of eight managed account providers in the GAO report on managed accounts in 401(k) plans dated June 2014 reported using a predetermined glide path to reduce participant risk over time. Differences in methodology can lead to conflicting advice for participants with similar characteristics. If we consider the target date fund glide path to be the best we can do, then why would something different be offered in the managed account? The answer to this question should be documented. Also, inevitably, one participant’s account is going to underperform another’s, and this can be an uncomfortable situation if the differences between the two approaches are not understood and documented.

2. Asset classes used in portfolio construction

Many times, the sets of asset classes included in portfolio construction differ between the target date fund and the managed account. That’s because managed accounts are built by using the plan’s core menu options. Many managed account providers have the ability to allocate to funds that are not included in the core lineup. The question becomes whether the plan’s recordkeeper can support additional funds. Plan sponsors should understand their recordkeeper’s ability to trade funds that are not in the core lineup, because more diversified portfolios can help soften the effects of market declines for participants. Plan sponsors should also consider their managed account provider’s ability to accommodate alternative investment strategies. Alternative investments are expected to make their way into target date funds in the future; at present, they may be excluded from managed account portfolios as a practical matter, when they do not appear attractive in terms of the managed account provider’s portfolio construction algorithm, and when an appropriate benchmark by which to judge whether the alternative investment strategy’s manager is adding value has not been identified.

From a governance standpoint, if a sponsor decides it is important for the target date fund to offer participants access to certain asset classes, then ideally the sponsor will seek to make those asset classes available to participants who are using managed accounts. Related to this, the use of active and passive management can also differ between the target date fund and the managed account. The plan sponsor should consider whether the asset class mapping strategy being developed with the managed account provider is in alignment with the sponsor’s overall set of beliefs on active and passive management.
3. Fees

The potential for customization and personalization provided by managed accounts comes at a cost. The cost is recurring, usually quarterly or annually, and is over and above the investment and plan administration fees. The “all-in” fees for target date funds and managed accounts will surely be different, with the cost of the managed accounts generally being higher. This fee difference is not unexpected, but it can pose questions about value received vis-à-vis fees charged, and about managed accounts’ suitability for those participants who have chosen them, but have not provided individual information on which to customize, and thus will likely receive an allocation similar to that designed for participants in target date funds, but at higher cost. Plan sponsors should be aware of how the fees of their target date fund and managed account compare, for participants of different ages and with different account balances. Plan sponsors should also seek to quantify the value gained by participants in a managed account program in exchange for the higher costs versus target date funds. This can be accomplished by comparing the net-of-fee performance results for participants with similar characteristics in the managed account and the target date fund, and by utilizing managed account reporting to track the improvements in retirement readiness experienced by participants using managed accounts over time.

4. Ongoing monitoring and reporting

The reporting provided to participants and plan sponsors tends to be quite different between target date funds and managed accounts. There are two primary reasons for this. First, managed accounts are not considered “designated investment alternatives” by the DOL, and therefore they do not currently carry the same participant disclosure requirements as target date funds do, for the provision of performance and benchmarking information to participants. Second, managed account reporting tends to be outcome-based, and to focus on income replacement and participant improvements in retirement readiness. Target date fund reporting focuses mainly on investment performance and asset accumulation. Eyeing the future, we expect the outcome orientation of managed account reporting to become a more prominent theme in target date fund reporting. Likewise, going forward, managed account providers may be required to provide additional performance disclosure information, based on recommendations to the DOL contained in the 2014 GAO report on managed accounts in 401(k) plans.³

The inconsistencies

We’ve highlighted four areas wherein inconsistencies may exist between target date funds and managed accounts. These inconsistencies can be attributed in part to the fact that there are different sets of providers for each of the solutions, and few firms offer both managed accounts and target date funds. Another driver is the limited set of choices plan sponsors have when it comes to selecting a managed account provider. The DOL’s guidance on fiduciary responsibilities encourages plan sponsors to consider several potential providers before hiring one, but oftentimes, the sponsor’s ability to select a managed account provider is confined to the range of options offered by the plan’s recordkeeper; sometimes, only a single managed account provider is offered. Sponsors can cover the cost of selecting and administering a managed account program not already on the recordkeeping platform, but this is very expensive, particularly for sponsors without a large budget for service provider fees.

The ability for plan sponsors to have true choice when it comes to selecting a managed account is central to this issue. Plan sponsors have been moving toward more open architecture arrangements over the past decade in their Tier 1 and Tier 2 investments, so logic would suggest that the same open architecture approach should be applied to the choice of managed account provider. The fact remains that managed account solutions can be costly and complex to integrate within a recordkeeping system, which is what makes recordkeepers hesitant to offer multiple solutions. And generally, plan sponsors also simply feel more comfortable selecting a managed account provider that is already offered by their recordkeeper.

**FOUR AREAS TO CONSIDER CONSISTENCY**

1. Methodology for generating the investment advice
2. Asset classes used in portfolio construction
3. Fees
4. Ongoing monitoring and reporting

The commentary up to this point is not meant to suggest that plan sponsors who offer target date funds should not offer managed accounts too. We believe, rather, that the two options are natural complements. For participants who wish to utilize managed accounts, personalization should lead to better asset allocations; and for participants who wish to customize/personalize or incur the extra fee, the simplicity of target date funds provides the next best thing. The worlds are beginning to come together, and in future we will likely see a blending of the best aspects of target date funds and managed accounts. In the meantime, offering participants professionally managed options has been shown to be beneficial. There is data to indicate that participants who seek out professional advice, either through a target date fund, managed account or financial advisor, tend to experience better investment performance after fees than those who do not.⁵ In particular, managed account users may also have higher savings rates, because they are encouraged to increase savings as a means of improving their retirement readiness, and they receive more customized reporting and access to additional retirement tools.
Conclusion

Target date funds are overwhelmingly the default option of choice for plan sponsors today and managed accounts are gaining in popularity. Both target date funds and managed accounts offer embedded asset allocation advice to participants, and while there is merit to providing access to both approaches, plan sponsors should be aware of the degree to which the asset allocation approach and investment strategy used by the managed account provider is consistent with asset allocation and investment strategy in the target date fund. In selecting a managed account provider, plan sponsors should give consideration to many of the same elements they assess when selecting their target date fund provider, such as glide path, capital market assumptions, income replacement rate, rebalancing frequency and bands, and the underlying investment options. Differences should be understood and documented. In selecting a managed account provider, the plan sponsor should also expand considerations to include candidates in addition to the firm or firms already offered by the recordkeeper. Finally, it is important to inquire about the recordkeeper’s ability to utilize non-designated plan investments in a managed account service, and to gauge the recordkeeper’s willingness and ability to provide a choice of managed account providers. In striving for more consistency between target date funds and managed accounts, plan sponsors can provide different types of asset allocation advice to participants while taking comfort in knowing that the methodology that has already been vetted for defaulted investors in the target date fund is being taken into account.

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