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Labs: Defined Contribution

PLAN SPONSORS:

Is your Proprietary Target-Date Fund a Trojan Horse for Underperforming Managers?

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Highlights

+ Many sponsors have opted for proprietary target-date fund solutions that offer only the asset management capabilities of a single company.
+ Plan sponsors are saddled with a fiduciary duty to ensure that the underlying investments of these products fulfill their ERISA responsibilities.
+ We believe a single-manager approach may be an antiquated plan design and it is time to consider a more balanced strategy.

Since the Pension Protection Act of 2006, target-date funds have become the Qualified Default Investment Alternative (QDIA) of choice for plan sponsors. In the 2016 PLANSPONSOR/Janus Capital Group DC Investment Study which received 4,600 plan sponsor responses, 60% of respondents believe target-date funds are the best QDIA choice for their employee population. For plans greater than $1 billion, the use of target-date funds is even more popular, as 85% of sponsors believe these vehicles represent the best QDIA option. There is no denying the appeal of an investment that provides a reasonable asset allocation based upon a participant's age, and which automatically becomes more conservative as the participant approaches retirement. After all, one of the generally accepted principles of modern portfolio theory states that 94% of the variability in investment returns is due to asset allocation policy[1]. Market timing and security selection represent a mere 6%.

Sensing an opportunity, many record-keepers have invested heavily in supplying the marketplace with target-date fund solutions, leveraging the investment capabilities of their in-house asset management divisions. More recently, even some mutual fund companies without a recordkeeping arm also launched target-date funds. Generally, these investment products are proprietary solutions that offer only the asset management capabilities of a single company. According to the 2016 PLANSPONSOR/Janus Capital Group survey, 41% of plan sponsors who use a target-date fund have adopted a proprietary solution, including 63% of $1 billion plans.

Given the growth and popularity of target-date funds, the landscape is starting to resemble the marketplace of the 1980s and 1990s. Many early defined contribution plans offered investment menus provided by a single manager. Recognizing that not all managers excel in all asset classes, the marketplace has evolved and today most plans employ an open-architecture approach to core menu construction. In fact, it is unusual for a plan's menu to use the same investment manager for more than two or three different asset classes. Yet, with target-date funds expected to represent 48% of defined contribution assets by 2020[2], are sponsors unknowingly reverting to an antiquated plan design?

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Our Experiment

We sought to answer the following question: Among the largest target-date funds available, how many of the underlying managers would pass customary Investment Policy Statement (IPS) criteria? An Investment Policy Statement is an important plan governance and fiduciary tool used by many plan sponsors. Plan fiduciaries who comply with a well-constructed IPS take an important step toward meeting certain ERISA responsibilities, including the duty of prudence. Among other things, an IPS defines criteria that sponsors use to evaluate and, if necessary, replace certain underperforming managers. More recently, many sponsors have amended their IPS to help benchmark their plan's overall target-date fund performance. Typically, this benchmarking exercise compares the plan's target-date funds to an index or industry peers. What most plan sponsors fail to account for, however, is whether the underlying funds in their target-date series would pass the same performance standards expected of its core menu managers.

> Among the largest target-date funds available, how many of the underlying managers would pass customary Investment Policy Statement (IPS) criteria?

Assumptions:

We started our experiment by selecting a single vintage, 2040, for consistency purposes. Using Morningstar, we then determined the 10 largest 2040 target-date funds ranked by assets. These managers are denoted by letters A through J on the next page. Finally, we deconstructed each target-date fund and assessed the underlying funds (institutional share classes) against our sample IPS. The sample IPS criteria were:

Category	Criteria
Expense ratio:	Top half
Manager tenure:	Longest named at least 5 years
Inception date:	At least 5 years
1-year performance:	Top half of peer group
1-year Sharpe ratio:	At least median of peer group
3-year performance:	Top half of peer group
3-year Sharpe ratio:	At least median of peer group
5-year performance:	Top half of peer group
5-year Sharpe ratio:	At least median of peer group

[1] "Determinants of Portfolio Performance," Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, 1986.
[2] Casey Quirk & Associates, 2011

Results:

Each box below represents the percentage of underlying funds that will pass our sample IPS criteria. For example, take Manager E and the 5-year performance metric. Based upon our analysis, 31% of the underlying funds in Manager E's 2040 target-date fund will meet or exceed the requirement that managers must rank in the top 50% of their peer group. In other words, 69% of this target-date fund's underlying managers would have failed our sample IPS criteria.

75% or higher | 50-74% | 49% or below

Target-Date Fund Manager	Expense Ratio	Manager Tenure	Inception Date	1-Year Performance	1-Year Sharpe Ratio	3-Year Performance	3-Year Sharpe Ratio	5-Year Performance	5-Year Sharpe Ratio
A	100%	71%	100%	88%	88%	88%	94%	82%	82%
B	100%	75%	75%	50%	75%	100%	75%	25%	25%
C	100%	54%	46%	54%	54%	58%	54%	38%	31%
D	100%	75%	75%	50%	75%	100%	75%	25%	25%
E	100%	54%	46%	46%	54%	46%	54%	31%	31%
F	100%	86%	90%	48%	48%	76%	71%	81%	71%
G	100%	100%	100%	83%	89%	89%	83%	94%	100%
H	100%	85%	90%	30%	40%	60%	60%	65%	65%
I	88%	65%	82%	76%	82%	76%	82%	65%	71%
J	94%	59%	65%	65%	65%	53%	47%	41%	41%

Source: Morningstar (as of 9/30/16)

Observations:

What should plan sponsors make of these results? We do not believe that one can immediately conclude that target-date fund Manager E is doing a poor job because the majority of the underlying funds would fail many plans' 5-year performance criteria. Remember that 94% of the variability of returns is due to the asset allocation, not security selection. Nonetheless, retaining poor underlying managers cannot possibly help maximize risk-adjusted returns. The question that also must be asked is, "Why has Manager E not proactively tried to improve the target-date product?" The inherent conflicts of interest should be clear:

> How can Manager E possibly replace an underlying fund that is also managed by his own company, especially when a superior alternative is offered by a competitor?

From the plan sponsors' perspective, suppose a plan's core menu small-cap value or emerging market fund turned in a consistent track record of poor performance. Under the terms of a plan's IPS, the manager would likely be placed on "watch" for a period of time, then promptly removed if performance did not improve after a probationary period. Why is the accepted practice, therefore, to maintain disappointing managers who have the luxury of being "hidden" as a component part of a target-date fund?

Plan sponsors and investment committee members need to remember that mutual fund companies are generally not plan fiduciaries. In other words, these service providers are not held to the same high standards or conflict of interest rules as those directly responsible for their organizations' retirement plans. Manager E is well within the boundaries to construct and offer any target-date product that is driven by his firm's business needs and demanded by the market. Plan participants, however, rely on target-date funds to meet their retirement goals, and plan sponsors are saddled with a fiduciary responsibility for vetting these products. We are asking plan sponsors to consider whether the time has come for a more balanced and reasonable approach.

Is a Better Solution Available?

What if plans can offer a target-date fund that can benefit from both the professional asset allocation guidance (which is the primary driver of return variability) and best-in-class underlying managers? The marketplace has evolved over the last few years and many of today's leading record-keepers have the ability to accommodate this construct. Often called custom target-date funds, there are two distinct approaches that can be used:

+ **Model Portfolio Approach:** In this recordkeeping solution, the plan administrator creates a set of model target date portfolios using all or a portion of the plan's core lineup. Typically, the underlying core funds are shown at the participant-account level. The model portfolios then dictate the asset allocation across the core funds.
+ **Trust Unitization Approach:** In this trust and recordkeeping system solution, each target date portfolio is set up as a separate account within the trust and as an individual investment option on the recordkeeping system, using all or a part of the core funds.

In both cases, plan sponsors are able to leverage the effort already used to select and monitor the plan's core menu. This approach ensures that only managers that meet strict IPS criteria are used to build the plan's target-date funds. In its February 2013 Tips for ERISA Plan Fiduciaries, the Department of Labor (DOL) suggested that plan sponsors "inquire about whether a custom or non-proprietary target-date fund would be a better fit for your plan," in part, for the reasons outlined above. The DOL points out that sponsors also need to investigate the costs and administrative tasks that may be associated with these approaches.

Next Steps

The bull market of the last eight years and rising participant balances may have lulled some sponsors into a false sense of security regarding their plan investments. Other plan sponsors are hyper-focused on fees, given the recent wave of class action lawsuits alleging excessive plan expenses. A new presidential administration may mean changes, particularly related to health care benefits and corporate taxation. In short, plan sponsors may not feel a sense of urgency to change their plan's target-date funds if 1) nothing appears to be wrong, or 2) there are competing priorities requiring time and attention.

Although understandable, we suggest investment committees at a minimum discuss this topic as a group and with your service providers, in particular your plan advisor. As a starting point, ask your plan advisor to run an analysis on the underlying managers of your plan's target-date funds. You may learn that no additional action is required. Or the results may prompt additional discussion about alternatives currently available. There is no right or wrong answer, best or worst product. The primary requirement is for plan sponsors to be informed, educated and deliberate. Raising these issues and asking the right questions help fulfill these important obligations.

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