Finding your way to custom target date solutions

A roadmap of key differentiators

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Previous articles in this strategy series discussed the evolution of custom target date solutions as a plan's qualified default investment alternative and key considerations for plan sponsors. In this article, we provide additional guidance—through the lens of the Department of Labor 2013 analysis—to evaluate off-the-shelf vs. custom options. You'll see that custom target date portfolios not only offer retirement plan sponsors and advisors the ease and flexibility to create a unique strategy that best meets their plan's needs. Their design provides greater control and oversight to pursue better outcomes.

One of the best features of target date funds is their all-in-one design. But therein lies the challenge. It can be hard to assess any differences or distinctions from one provider's target date funds to another when selecting an option for a retirement plan menu.

There has been a huge rise of inflows into traditional off-the-shelf options, especially following the Pension Protection Act of 2006. It's not surprising then that plan sponsors and advisors have sought to better understand how the growing number of options compare. Heeding these calls back in 2013, the Department of Labor (DOL) issued general guidance highlighting key elements for consideration. But, with the advent of custom target date portfolios, assessing options and opportunities has become even more of a challenge.

That's why we thought it would be helpful to revisit the basic DOL guidance and to provide a roadmap of sorts to better navigate the options available today. When you consider the various elements in the context of a custom target date strategy, their value proposition becomes even more compelling for their impact on plan participants and outcomes.

Key elements for evaluating target date strategy options

The DOL's 2013 guidance was broad, encompassing a range of aspects to be considered, including employee communications and documentation. We have chosen to focus on the following elements of target date strategies—whether off-the-shelf or customized—to better understand how they can impact plan performance and participants:

- Overall fund structure and philosophy
- Glidepath design

- Allocation and individual component selection within age-based funds
- Expected performance and volatility
- Fees and costs
- Post-retirement provisions

Let's take them one at a time to understand some of the key differences and differentiators.

Overall fund structure and philosophy

The vast majority of off-the-shelf target date strategies available in the market today follow a one-size-fits-all approach. While most target date fund series follow an age-based design, there is really no consideration for investors' differing risk appetites, their degree of investment sophistication, their expected tenure within the organization, or other factors that may be relevant differentiators.

Today's custom portfolio designs can appeal to a broader set of participants and so lessen the need for an extensive investment menu and the costs associated with maintaining it. The reason for this is that within the design, they can include additional features such as the ability to allow participants to choose risk levels within a given age class fund. Depending on the design, participants may also be able to select from among different levels of complexity based on their retirement horizon, sophistication and expected plan tenure.

Glidepath design

For most traditional target date fund series, the glidepath design is non-negotiable. Plan sponsors can choose among any fund available in a series but can't tailor the individual target date fund. This is unfortunate because an organization may want a slightly more aggressive or conservative approach; it may want a structure that includes retirement income components or multiple glidepaths to suit the needs of conservative, moderate or aggressive investors.

This is what custom portfolio models are designed to provide. Plan sponsors can control glidepaths and customize offerings to suit a range of participant objectives.

Allocation and individual component selection within age-based funds

Perhaps the most discussed elements of target date strategies is the selection and allocation of underlying funds. In all or virtually all off-the-shelf target date funds, component funds are made up of offerings from the underlying fund company. So, one target date series from Manager X will contain the growth, value, small cap, money market and fixed income funds from Manager X. This typical arrangement is very convenient and profitable for Manager X, but it might not be in the best interest of the plan. A plan sponsor or advisor might prefer a different fixed income strategy or a specialist growth or value manager or other fund allocations that are not readily available off the shelf.

This is one of the primary benefits of customized approaches—plan sponsors and advisors are able to exercise control, selection and oversight of the underlying funds within the target date series.

Expected performance and volatility

A classic approach—and a classic mistake—is to put too much weight on past performance and volatility measures without really understanding the environment that produced those results. Unfortunately, these are the common measures readily reported for funds and they can be misleading.

Let's consider an example. On the surface, Fund Series A may have outperformed Fund Series B by these measures. What you would not know is it did so in an environment where small cap stocks strongly outperformed, thus benefitting the results of Fund Series A, which happened to be very heavily weighted in small caps compared to Fund Series B. If small cap stocks fall out of favor in a future measurement period, Fund Series A won't perform as well.

In a custom target date portfolio series, plan sponsors and advisors can focus efforts where they have direct control and where they can have a meaningful impact such as the series' objectives, features and benefits, and overall design and cost structure.

Fees and costs

The fees and costs of any investment program are highly visible and closely watched. Suffice it to say that plan sponsors and advisors are diligent in managing the costs of any target date program, whether off the shelf or a customized solution. It's important to note that both have investments with their own expense ratios, and if you opted for a custom option, there could be additional fees.

But, fees are not the only factor critical in investment programs. If they were, investors would only buy the lowest-cost solution without regard to other program elements.

When building customized solutions, plan sponsors and advisors can evaluate costs in the context of the value received. For instance:

- Some plan sponsors building customized target date solutions may wish to have a "best in class" lineup of high-performing funds. They may be willing to pay higher fees in the hope that the added value offsets the fees compared to, say, an index-based alternative.
- Others may choose to mix indexed and active strategies with an eye toward maintaining tight cost controls in efficient markets while seeking to add value in less-efficient parts of the global arena.

Both of these alternatives are perfectly reasonable and sound approaches if executed efficiently. With custom target date portfolios, you can build the solution with full knowledge and freedom to assess the relative costs and benefits.

Post-retirement provisions

The DOL's 2013 guidance only briefly touched on this last factor. Income in retirement still gets relatively little attention, but is perhaps one of the most critical elements when assessing plan outcomes. Participants may spend 30-40 years accumulating in a target date fund over their career and then spend an additional 20-30 years in retirement. Target date strategies have done an admirable job in providing expert asset allocation guidance through the accumulation years, but most offer few, if any, options that systematically deliver retirement income.

You could argue that each individual has different post-retirement needs and resources so it is difficult to describe a compact set of options to satisfy them all. Still, we believe that there are some basic options that could be offered despite the wide variety of participant needs. After all, the U.S. Social Security system has a very narrow set of offerings but these broadly meet the needs of tens of millions of Americans in retirement.

Custom target date portfolios offer flexibility that can address the following issues:

Post-retirement costs—Off-the-shelf target date funds aren't specifically designed to help participants keep up with income needs in retirement. Consequently, participants may need to seek out other investment avenues or advice sources, which can be subject to very high fees. The use of independent financial advisors is growing in popularity, but the cost of these services takes a substantial bite from participants' wealth and income. For example, an individual with $1 million in retirement savings may pay an advisor a 1% annual fee to manage his or her account. While this seems reasonable on the surface, it amounts to $10,000 in the first year—a significant payment for a retiree. If we follow the 4% rule of thumb for retirement spending, our individual with $1 million can withdraw $40,000 in the first year but $10,000 of that—or 25% of retirement income—will go to pay the advisor. Plan sponsors can build a custom target date strategy with retirement income in mind, to provide a more cost effective solution.

Income elements—One of the key attractions of custom target date strategies is the ability to include income-paying vehicles such as fixed or variable annuities into their structure. Such components are not available to off-the-shelf target date funds because of regulatory requirements that limit underlying components to tradable funds or securities. For a large segment of the plan participant population, annuities can be a very meaningful addition to their portfolio. Fixed annuities can provide stable growth potential during the accumulating years and help solve key challenges when it's time to draw income, such as assuring a low-cost source of income and providing lifetime income. While variable annuities bring together the power of diversified investing with regular income payments during retirement. Even while retirees are taking income, variable annuities remain invested across their specific asset classes, strategies, styles, and sectors to potentially grow and help weather inflation and other risks. Because variable annuities adjust with market performance, the amount of a given payment may increase or decrease.

A personalized plan—An emerging topic for some plan sponsors is the idea of integrating a degree of personalized advice or guidance into the retirement income phase of customized target date strategies. Because custom portfolio models can have a higher allocation of equities into retirement to enable continued growth, the ability to discuss how much allocation and for how long can be highly personal based on the participant's goals, concerns for risk and sources of other income. Although an advice offering may not, strictly speaking, be part of the strategy, it can be integrated to work alongside a customized strategy so long as the participant maintains a balance in the customized target date solution.

Following your own roadmap

By breaking down the key elements of target date strategies, it's easy to see why custom approaches, which can tailor strategies to better fit participants' needs, are catching on. No longer exotic or just for the largest of plans, this discussion provides a roadmap for considering how a custom target date approach could work in your plan. With so much potential for better outcomes, the question shouldn't be why offer custom target date portfolios on your menu, but why not.

For complete information on the DOL guidelines you can view the entire paper at: **www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf**

For additional information about custom portfolios, you can read the other articles in this series of papers. To see how a custom portfolio can support your plan's and participants' goals, please contact your TIAA representative.

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