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Default Investment Strategies for Defined Contribution Plans

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As defined contribution plans have progressed to automatic enrollment and allow participant investment direction, the need for an effective default investment strategy has become more acute. In the U.S., this has been codified in the Pension Protection Act of 2006 and the subject of final regulations issued by the U.S. Department of Labor.

Plan fiduciaries have considered several alternatives in developing their respective default investment strategies. The most popular alternatives have been target date funds, lifecycle funds, balanced funds, managed accounts sponsored by banks and insurance companies and in-house managed funds.

Target date funds have been the most popular in the U.S., but have created some confusion among investing plan participants and plan fiduciaries. Performance by many target date funds since the economic crisis of 2008-09 has been disappointing and caused many plan fiduciaries to reconsider their default investment strategies. Both the U.S. Department of Labor and Securities Exchange Commission have since proposed rules requiring greater disclosure by target date funds.

Critics of target date funds have cited the conflicts-of-interest created by the fund-of-funds structure of most target date funds and potentially excessive fees created thereby. This has created a new landscape for plan fiduciaries in developing their default investment strategies.

Introduction

In an era of participant-directed investments under defined contribution plans, the subject of default investment strategies has come front-and-center in the last 5 years. This is particularly so since such plans have been modified to provide for automatic enrollment of participants, many of whom are not aware of their ability to direct investments or simply do not take the time to do so, at least initially.

Since relevant provisions of the Pension Protection Act of 2006 became effective in 2007, a defined contribution plan participant who does not submit investment instructions to the plan administrator will be treated as exercising control over the assets in his or her account if the plan's fiduciaries default investments are made in accordance with final regulations issued by the U.S. Department of Labor (**DOL**).

As a result, many plan fiduciaries have looked to target date funds for default investments, among other alternatives. This has led to varying results, especially during the financial market reversals of 2008-09 and has caused the DOL to re-think its default investment rules.

Target Date Funds

Target date funds, which are also often called lifecycle funds, are designed to offer a convenient way to invest for a person expecting to retire at or about a particular date. A target date fund pursues a long-term investment strategy, using a mix of asset classes (or asset allocations) that the fund provider adjusts to become more conservative over time.

These funds are designed to help investors avoid some of the most common investment errors. Typically, they include the following features:

- Diversification across asset classes
- Avoidance of extreme asset allocations
- Automatic rebalancing
- Automatic adjustment for changing risk profile

Funds providers normally offer target date funds with target dates spaced at either 5 or 10-year intervals to meet the needs of retirement investors across a wide range of ages. A person anticipating retirement in 2028 could invest in 2030 fund, while a person expecting to retire in 2018 might choose between a 2015 fund or a 2020 fund, or a combination thereof.

Note that the target date does not necessarily mean the date at which an investor should cash out the entire target date fund investment. Normally, target date funds are designed to be held beyond the expected retirement date to offer a continuing investment option for the investor at retirement. In addition, target date does not mean the date at which fund arrives at its most conservative asset allocation.

There is a technical difference between lifestyle funds and target date funds. Lifestyle funds offer a mix of asset classes to provide a predetermined level of risk and generally use terms such as "conservative", "moderate" or "aggressive" in their names to reflect the fund's level of risk. Lifestyle funds do not change their asset allocations over time. Target date funds, on the other hand, are usually identified by their specific target date ("2015 fund" or "2020 fund") and adjust their asset allocations over time to become more conservative.

Target date funds are offered by mutual funds, banks, trust companies and insurance companies. They are typically offered to 401(k) and other defined contribution funds, to IRA investors, and to individuals saving for retirement outside of tax-favored retirement programs. Most target date funds are funds of funds of the family offering the target date alternatives. This is the case with the three largest U.S. providers – Fidelity, Vanguard and T. Rowe Price – who control together about 80 percent of the assets in target date funds.

Performance Issues

After some promising performance during 2005-07, target date funds took a turn for the worse in 2008-09 consistent with overall financial market performance. The average investment loss for funds with a target date of 2010 was roughly 25 percent due to market turmoil in 2008, with individual losses running as high as negative 41 percent, according to an analysis by the Securities Exchange Commission. This has drawn the attention of Congress, the DOL, plan sponsors, plan fiduciaries and other stake holders. In the meantime, performance by target date funds during 2010 and 2011 was relatively flat to modest. Despite widespread criticism, the average fund nearing retirement today has 40 percent of its assets in stock, down only three percentage points from 2008.

DOL Reaction

In 2007, DOL issued final regulations that provide relief to plan fiduciaries who invest plan assets in qualified default investment alternatives (**QDIA**s) in the absence of participant investment direction. The final rules are designed to make it easier for fiduciaries of 401(k) plans and other participant-directed defined contribution plans to adopt automatic enrollment features.

Under the final regulations, fiduciary relief is conditioned on compliance with the following:

- Assets must be invested in a QDIA,
- Participants on whose behalf assets are being invested in a QDIA must have had an opportunity to direct the investment of assets in the individual account and failed to direct the investment of assets,
- Participants must receive an advance initial notice and annual notice regarding the investments on their behalf,
- Materials provided to the plan relating to a participant's investment in a QDIA (account statement, prospectus, proxy voting rights) must be provided to the participant, and
- A participant whose assets are invested in a QDIA must be given the opportunity to transfer such assets to any other investment alternative under the plan without financial penalty.

A QDIA must satisfy the following requirements:

- The QDIA may generally not hold or permit the acquisition of employer securities,
- The QDIA may not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer investments from a QDIA to another investment option, and
- The QDIA must be managed by an investment manager or a registered investment company.

The final rules authorize plan sponsors who are named fiduciaries (*e.g.*, investment committee) to manage QDIAs. The plan sponsor may utilize asset allocation models to manage and allocate assets and may employ an investment consultant (who would be subject to ERISA's fiduciary duties).

Specifically, the final regulations provide that a QDIA may be a target date fund, lifecycle fund, a balance fund or a professionally-managed account.

In November 2010, DOL proposed an amendment to the final regulations that will require plan administrators to provide more information to employees about the role of target date funds in their retirement plans.

Under the proposed rule, plan administrators would have to provide information about how a particular target date fund allocates investments among stocks, bonds and cash and how that allocation will change over time.

Moreover, an explanation of what a "target date" means would also have to be provided. The proposed rules would also require that a written statement be provided to plan participants concerning the risk that a participant investing in a target date fund may lose money in a target date fund, even close to retirement.

For example, one fund company might have a 2015 target date fund designed to provide a lump sum to an investor upon retirement in 2015 while another fund may be designed to last past retirement for a period certain. Such a difference has caused much confusion among plan participants. Some participants invested in target date funds believing them to be invested in fixed income instruments only two years out from their expected retirement date. However, many funds dropped in value where the funds were designed to last another 20 years and thus had substantially stock market exposure (with some funds invested 65 percent or more in stocks).

Critics have noted that the DOL's designation of target date funds as a qualified default investment alternative for participant-directed investments has provided a measure of protection for plan sponsors, but the rules mask a structured flow that places retirement savings at risk and could, ultimately, expose plan sponsors to liability.

The root of the problem, the argument goes, is the fund-of-funds structure of target date funds and the use of affiliated underlying funds, thereby creating conflicts of interest. A target date fund is a separate legal entity, often a corporation or a business trust, with its own board of directors or trustees charged with protecting the interests of the fund's shareholders, including retirement plan and their participants.

The mutual fund industry has responded that these independent boards prevent a fund manager's interests from taking priority over the interests of plan participants. However, the reality is that product design is driven by business considerations and the target date funds are not created solely in the interests of plan participants. In creating a fund, the fund family has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing overall compensation through fees paid to underling fund managers.

This compensation is in addition to any wrap-fee that is charged directly by the manager of the target date fund. In fact, many target date funds have higher expense ratios than the rest of the core portfolio in 401(k) plans, according to a report prepared by the Senate Special Committee on Aging. Perhaps, the new fee disclosure rules will help modify this situation over time.

A related conflict arises with respect to the mix of funds that underlie the target date fund. Equity funds normally charge higher fees than other funds and this creates an incentive to design the target date fund so that it has a higher exposure to equity and thereby increase overall fees and the fund's volatility. Plan sponsors need to take this into consideration in selecting a QDIA.

This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds and thereby overweighs equity investments for the fund.

ERISA Fiduciary Status of Target Date Fund Managers

Section 3(21) of ERISA provides that a plan's investment in a mutual fund:

> *'shall not by itself cause such [fund] or such [fund's] investment advisor or principal under-writer to be deemed to be a fiduciary'.*

While this provision provides a broad exemption from ERISA fiduciary liability for target date fund managers and advisors, the exemption is not absolute. Moreover, a plan administrator remains responsible for selecting and monitoring target date funds as default investment options.

Accordingly, plan administrators should be considering target date fund providers which minimize the conflicts found in most target date funds. Where possible, sponsors should also seek out providers that acknowledge their fiduciary status under ERISA. Target date funds are available which are more transparent and have lower fees, unconflicted managers and investment services delivered in accordance with the fiduciary standards of ERISA.

Other QDIA Alternatives

Plan administrators should also give due considerations to other QDIA types of investments, including

- Balanced funds or portfolios,
- Managed accounts sponsored by banks or insurance companies, and
- In-house funds managed by named fiduciary.

These latter alternatives are specified in DOL regulations on QDIA's and are used by many plans in an attempt to avoid many of the problems encountered by target date funds and lifecycle funds. Substantial diligence is still required in selecting and monitoring a QDIA provider and target date funds should not be dismissed as a viable alternative.

SEC Regulation

Target date funds offered by mutual fund companies are subject to the Investment Company Act of 1940, like any other mutual fund. The Securities Exchange Commission (SEC) has broad powers under the 1940 Act to regulate the activities of mutual funds in the public interest and for the protection of investors. The 1940 Act does, in fact, impose detailed requirements and prohibitions on the structure, governance and daily operations of mutual funds – rules designed to provide investors with adequate information, protect fund assets, prohibit or regulate conflicts of interest and self-dealing, and ensure fair valuation of investor purchases and redemptions. Mutual funds are also subject to regulation under the disclosure and advertising rules of the Securities Act of 1933 and, thus, target date mutual funds must explain their asset allocation approaches and glide paths in disclosure documents required by the SEC.