The Looming Liability of Target Date Funds
Proliferation of Target Date Funds (TDFs)

- **One of the most widely used** investment options in defined contribution (DC) plans
- **70% of total DC assets by 2020**¹

### TDF Assets Under Management in $Billions

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>65</td>
<td>174</td>
<td>244</td>
<td>363</td>
<td>609</td>
<td>763</td>
</tr>
</tbody>
</table>

Source: Morningstar mutual fund data, Elston Consulting compilation and illustration © Elston Consulting Ltd. (UK)
Source: Morningstar Asset Flows, US Open-end & ETF Target Date Funds, Exclude Obsolete Funds
¹Center for Due Diligence
Extreme differences in returns create significant risks for plan participants and plan fiduciaries

-31%
Our goal is to provide a framework to evaluate a plan’s TDF series.
Discussion Topics

1. Fiduciary Duties
2. Prudent Steps
3. Custom Solutions
Fiduciary Duties
In general, **plan fiduciaries** should engage in an **objective process** to obtain information that will enable them to evaluate the **prudence of any investment option** made available under the plan.

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The full fact sheet is available at [http://www.dol.gov/ebsa/newsroom/fsTDF.html](http://www.dol.gov/ebsa/newsroom/fsTDF.html).
DOL’s TDF Recommendations

- Align TDF and participant characteristics
- Understand underlying investments
- Review fees and investment expenses
- Consider custom or non-proprietary options
- Develop effective employee communications
- Document the process

Aligning Participant and TDF Characteristics

- Salary Levels
- Savings Rates
- Plan Balances
- Withdrawal Patterns

Participant

- Glidepath
- Asset Classes
- Component Fund Strength
- Fees

TDF
Prudent Steps
Multi-step Suitability and Selection Process

Step 1: Suitability Analysis
- Funding Adequacy
- Participant Tendencies
- Glidepath Risk Postures

Step 2: Qualitative Considerations
- Active/Passive¹
- Single Manager² / Multi Manager³
- Asset Class Coverage

Step 3: Performance Analysis
- Risk/Return Comparisons
- Underlying Fund Performance

¹Active/Passive: describes the management style of the underlying funds within the series.
²Single Manager: one manager manages the underlying funds within the suite.
³Multi Manager: multiple managers manage the underlying funds within the suite.
### Step 1 - Funding Adequacy

- Prudent to de-risk sufficiently funded portfolios
- Imprudent to de-risk insufficiently funded portfolios

### TDF Risk Postures

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
</table>
| **Conservative** | - Less than 30% equity exposure at retirement  
                      - Transition from risky assets is long and gradual                       |
| **Moderate**    | - 30-40% equity exposure at retirement (less than 30%)  
                      - Transition from risky assets begins 20-30 years from target date       |
| **Aggressive**  | - Greater than 40% equity exposure at retirement  
                      - Transition from risky assets begins 10-20 years from target date        |
Step 1 - Participant Tendencies

- Participant Withdrawal Patterns
- Investment Knowledge
- Risk Tolerance

TDF Risk Postures

| Conservative       | • Less than 30% equity exposure at retirement  
|                    | • Transition from risky assets is long and gradual |
| Moderate           | • 30-40% equity exposure at retirement (less than 30%)  
|                    | • Transition from risky assets begins 20-30 years from target date |
| Aggressive         | • Greater than 40% equity exposure at retirement  
|                    | • Transition from risky assets begins 10-20 years from target date |
Step 1 - “Best Fit” Glidepath Risk Posture

<table>
<thead>
<tr>
<th>Funding Adequacy</th>
<th>Participant Tendencies</th>
</tr>
</thead>
</table>
| Conservative     | • Less than 30% equity exposure at retirement  
                  | • Transition from risky assets is long and gradual |
| Moderate         | • 30-40% equity exposure at retirement (less than 30%)  
                  | • Transition from risky assets begins 20-30 years from target date |
| Aggressive       | • Greater than 40% equity exposure at retirement  
                  | • Transition from risky assets begins 10-20 years from target date |
Step 1 - TDF Glidepaths

TDF equity allocations at retirement can vary by as much as 50%.

Data as of 1/31/2012. Source: Morningstar, Inc.
Past performance is not indicative of future results.
The multiple lines represent various TDF glidepath options available within the market place.
## Step 2 - Qualitative Considerations

<table>
<thead>
<tr>
<th>Product Name</th>
<th>TDF Design Analysis</th>
<th>Equity Glide Path (Approx.)</th>
<th>Roll Down</th>
<th>Approx. Equity Exposure at Age 65</th>
<th>Active/Passive</th>
<th>Invst. Type</th>
<th>Asset Class Coverage</th>
<th>Comments/Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative Glide Path TDF Series</td>
<td>Conservative</td>
<td>81%</td>
<td>18%</td>
<td>Age 35</td>
<td>Age 65</td>
<td>18%</td>
<td>Active Proprietary Funds Core plus TIPS, EM, REITs, HY, Global Fixed, Commodities</td>
<td>These funds incorporate Pimco fixed income funds and Allianz equity funds into a conservative &quot;to retirement&quot; glide path. Take a fully active approach and tend to be more expensive than its peers.</td>
</tr>
<tr>
<td>Moderate Glide Path TDF Series</td>
<td>Moderate</td>
<td>90%</td>
<td>35%</td>
<td>Age 35</td>
<td>Age 65</td>
<td>35%</td>
<td>Active and Passive Proprietary Funds Core plus EM, Commodities, Sector funds, Market Neutral</td>
<td>Uses a very broad range of asset classes but only uses DWS funds and appears to be an &quot;all in&quot; approach. Normal glide path but expenses appear to be higher than its peers.</td>
</tr>
<tr>
<td>Aggressive Glide Path TDF Series</td>
<td>Aggressive</td>
<td>90%</td>
<td>40%</td>
<td>Age 40</td>
<td>Age 80</td>
<td>60%</td>
<td>Active Proprietary Funds Core plus TIPS, EM, REITs, HY, Global Fixed</td>
<td>Tend to be very aggressive with high weightings to equity, HY and REITs across the entire glide path. Have the belief that most participants are underfunded and need to be aggressive to make up for their underfunding.</td>
</tr>
</tbody>
</table>
Step 3 - Performance Analysis

TDF performance comparisons should evaluate the TDF and the underlying funds that are used to construct the TDF.

### 10 Point Pass/Fail Scoring System

<table>
<thead>
<tr>
<th></th>
<th>Acceptable scores</th>
<th>Watch list or replace scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 - 10</td>
<td>6 or less</td>
<td></td>
</tr>
</tbody>
</table>

### Analysis Begins with Creating

- Custom benchmarks
- Custom peer group universes

<table>
<thead>
<tr>
<th></th>
<th>Style-related calculations</th>
<th>Benchmark-related calculations</th>
<th>Peer group-related calculations</th>
<th>Qualitative calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Average style</td>
<td>• Average risk/return</td>
<td>• Median return rank</td>
<td>• Manager tenure</td>
</tr>
<tr>
<td></td>
<td>• Style drift</td>
<td>• Up/down capture ratio</td>
<td>• Median information ratio rank</td>
<td>• Average peer group fund expense</td>
</tr>
</tbody>
</table>
### Step 3 - TDF Series & Underlying Fund Scores

#### Asset Allocation Series Underlying Funds

<table>
<thead>
<tr>
<th>Active</th>
<th>Ticker/ID</th>
<th>Style</th>
<th>Risk/Return</th>
<th>Peer Group</th>
<th>Qual.</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>U.S. Equity</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Small Cap Blend</td>
<td></td>
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<tr>
<td></td>
<td>Micro Cap I</td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Small Cap Growth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>International Large Cap Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>International Equity</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>International Large Cap Blend</td>
<td></td>
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<tr>
<td></td>
<td>International Large Cap Growth</td>
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<tr>
<td></td>
<td>International Growth</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>International Small-Mid Cap Value</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Intl Sm Cp</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

#### Asset Allocation Series

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC TDF Series</td>
<td>8</td>
<td>8</td>
<td>7,6</td>
<td>6,6,4,4,4</td>
</tr>
</tbody>
</table>
Custom Solutions
A plan’s “average” participant characteristics are matched to available off-the-shelf glidepaths.

¹Single Glidepath: a single formula that defines the asset allocation mix of a target date fund, based on the number of years to the target date.

²Single Investment Manager: one investment manager is responsible for managing all of the assets in the target date fund.
Version 1.0 - Challenges

1. Single glidepath
2. Single investment manager
The DOL recommends inquiring whether a custom or non-proprietary TDF would be a better fit for your plan.
A tailored glidepath is created based off of a plan’s “average” participant characteristics.
Version 2.0 - Custom TDF Glidepath

Data as of 1/1/15. Source: Morningstar, Inc.
Past performance is not indicative of future results.
The core fund lineup is used to create the Custom TDF portfolio.
Version 2.0 - Challenges

1. Not unitized
2. Single glidepath
3. No portability across recordkeepers
4. No access to funds outside plan lineup
If the employees don’t understand the fund's glidepath assumptions when they invest, they may be surprised later if it turns out not to be a good fit for them.
Misfit risk occurs when a participant’s actual savings rate differs from the TDF’s assumed savings rate.

Distribution of Participant Employee-Elective Deferral Rates

- 53% of participants have savings rates below 6%.
- 25% have savings rates between 6% and 10%.
- 22% have savings rates above 10%.

1 Best-fit risk postures are based solely on funding adequacy. Conservative: Less than 30% equity exposure at retirement. Moderate is between 30-40% equity exposure at retirement. Aggressive is greater than 40% equity exposure at retirement.

Individual participant information is matched to one of three glidepaths based on projected funding adequacy.

Plan Purpose

**Individual**

Savings Rate

**Individual**

Plan Balances

**Individual**

Withdrawal Pattern

**Individual**

Risk Tolerance

Multiple Glidepaths

Best-in-Class Managers

Non-Core Asset Classes

Version 3.0 flexPATH
Multiple glidepaths help solve for misfit risk by giving participants three risk options so each can select the glidepath best suited for their own needs.
Non-core funds are added to provide additional diversification benefits.
Other Advantages of Version 3.0

Collective trust fund structure mitigates prohibitive construction and maintenance costs.

1. Unitized structure
2. Collective buying power
3. Portability across recordkeeping platforms
4. Access to funds outside plan lineup
The Evolution of TDFs

**Version 1.0**
- Traditional TDFs
  - Unitized structure
  - Single glidepath
  - Single manager

**Version 2.0**
- Custom TDFs
  - Tailored glidepath
  - Multiple managers
  - Single glidepath
  - Non-unitized structure
  - Investment limitations

**Version 3.0**
- Multi-glidepath TDFs
  - Unitized structure
  - Multiple glidepaths
  - Multiple managers
  - Open architecture
Key Takeaways

1. Fiduciary Duties
2. Prudent Steps
3. Custom Solutions
What to Remember When Choosing Target Date Funds

• Establish a process for comparing and selecting TDFs. In general, plan fiduciaries should engage in an objective process to obtain information that will enable them to evaluate the prudence of any investment option made available under the plan. For example, in selecting a TDF you should consider prospectus information, such as information about performance (investment returns) and investment fees and expenses. You should consider how well the TDF’s characteristics align with eligible employees’ ages and likely retirement dates. It also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns.

• Establish a process for the periodic review of selected TDFs. Plan fiduciaries are required to periodically review the plan’s investment options to ensure that they should continue to be offered. At a minimum, the review process should include examining whether there have been any significant changes in the information fiduciaries considered when the option was selected or last reviewed. For instance, if a TDF’s investment strategy or management team changes significantly, or if the fund’s manager is not effectively carrying out the fund’s stated investment strategy, then it may be necessary to consider replacing the fund. Similarly, if your plan’s objectives in offering a TDF change, you should consider replacing the fund.

• Understand the fund’s investments – the allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time. Have you looked at the fund’s prospectus or offering materials? Do you understand the principal strategies and risks of the fund, or of any underlying asset classes or investments that may be held by the TDF? Make sure you understand the fund’s glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date. Some funds keep a sizeable investment in more volatile assets, like stocks, even as they pass their “target” retirement dates. Since these funds continue to invest in stock, your employees’ retirement savings may continue to have some investment risk after they retire. These funds are generally for employees who don’t expect to withdraw all of their 401(k) account savings immediately upon retirement, but would rather make periodic withdrawals over the span of their retirement years. Other TDFs are concentrated in more conservative and less volatile investments at the target date, assuming that employees will want to cash out of the plan on the day they retire. If the employees don’t understand the fund’s glide path assumptions when they invest, they may be surprised later if it turns out not to be a good fit for them.

• Review the fund’s fees and investment expenses. TDF costs can vary significantly, both in the amount and types of fees. Small differences in investment fees and costs can have a serious impact on reducing long term retirement savings. 2 Do you understand the fees and expenses, including any sales loads, for the TDF? If the TDF invests in other funds, did you consider the fees and expenses for both the TDF and the underlying funds? If the expense ratios of the individual component funds are substantially less than the overall TDF, you should ask what services and expenses make up the difference. Added expenses may be for asset allocation, rebalancing and access to special investments that can smooth returns in uncertain markets, and may be worth it, but it is important to ask. 2 A difference of just one percentage point in fees (1.5% as compared with 0.5%) over 35 years dramatically affects overall returns. If a worker with a 401(k) account balance of $25,000 averages a seven percent return, the worker will have $227,000 at retirement with the lower fee and $163,000 with the higher fee, assuming no further contributions. U.S. Department of Labor, Employee Benefits Security Administration, A Look At 401(k) Plan Fees, at http://www.dol.gov/ebsa/publications/401k_employee.html.

• Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan. Some TDF vendors may offer a pre-packaged product which uses only the vendor’s proprietary funds as the TDF component investments. Alternatively, a “custom” TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan’s existing core funds in the TDF. Nonproprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants’ exposure to one investment provider. There are some costs and administrative tasks involved in creating a custom or nonproprietary TDF, and they may not be right for every plan, but you should ask your investment provider whether it offers them.
Develop effective employee communications. Have you planned for the employees to receive appropriate information about TDFs in general, as a retirement investment option, and about individual TDFs available in the plan? Just as it is important for the plan fiduciary to understand TDF basics when choosing a TDF investment option for the plan, employees who are responsible for investing their individual accounts need information too. Disclosures required by law also must be considered. The Department published a final rule that, starting for most plans in August 2012, requires that participants in 401(k)-type individual account retirement plans receive greater information about the fees and expenses associated with their plans, including specific fee and expense information about TDFs and other investment options available under their plans. The Department of Labor is also working on regulations to improve the disclosures that must be made to participants specifically about TDFs. For example, in addition to general information about TDFs, the proposed regulations call for disclosures to include an explanation that an investment in a TDF is not guaranteed and that participants can lose money in the fund, including at and after the target date. Check EBSA’s website for updates on regulatory disclosure requirements.

• Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection. While TDFs are relatively new investment options, there are an increasing number of commercially available sources for information and services to assist plan fiduciaries in their decision-making and review process.

• Document the process. Plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options.

Related Information

From the Department of Labor:

• Investor Bulletin: Target Date Retirement Funds
• A Look at 401(k) Plan Fees
• Meeting Your Fiduciary Responsibilities
• Understanding Retirement Plan Fees and Expenses
• Understanding Your Retirement Plan Fees
• Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries

From the SEC:

• Beginners’ Guide to Asset Allocation, Diversification, and Rebalancing
• Invest Wisely: An Introduction to Mutual Funds
• Mutual Fund Fees and Expenses

From the Financial Industry Regulatory Authority (FINRA):

• Fund Analyzer
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The target date is the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis with the asset allocation becoming more conservative as the fund nears the target retirement date.

Mutual funds are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund. The fund prospectus provides this and other important information. Please contact your representative or the Company to obtain a prospectus. Please read the prospectus carefully before investing or sending money. NFPR-2014-64 ACR#175067 03/16