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Employee Benefits &
Executive Compensation Alert
May 2010

Target Date Funds: Missing the Target and Hitting the Fiduciaries?

Target date funds (also frequently referred to as "lifecycle funds") have become a popular investment choice to help guide 401(k) plan participants on a path to retirement (*e.g.*, using a "2025 fund" if you are scheduled to retire in 2025). These funds provide a vehicle for investing in a mix of assets through a single mutual fund that – if it works the way it was designed – should both rebalance its asset allocation periodically and shift its focus from growth to income as the participant approaches retirement. However, these funds are not as simple as often presented by the fund providers and must be carefully examined by plan fiduciaries to protect plan participants and prevent potential liability. In addition, the poor investment performance of many target date funds in recent years has caused these funds to come under increased scrutiny from the U.S. Department of Labor (DOL) and the Securities and Exchange Commission (SEC), as well as the U.S. Senate.

Background

In general, the asset allocation mix of target date funds varies over time, becoming more conservative each year by reducing the fund's equity (stock) exposure and keeping the participant's investment in an "age-appropriate asset allocation" throughout his or her life. The pattern of how the allocation of assets varies over time is typically called the target date fund's "*glide path*." With many retirement plan participants not saving enough to retire comfortably, and too many plan participants making poor investment choices or not knowing anything about the choices that they make, target date funds were established to be the "no thought required" alternative for retirement investing.

However, the losses sustained by target date funds during the economic downturn – the average 2010 target date fund lost 26 percent of its value in 2008 – have raised concerns about the design and transparency of target date funds. Furthermore, research has also shown that most investors do not understand what they are investing in when they choose target date funds. Even worse, some plan fiduciaries may not understand what they are offering to employees participating in their plans when they choose to allow investments in target date funds.

The complexity of these funds becomes apparent by examining the differences among funds carrying the same target retirement date (*i.e.*, "2010 funds," "2025 funds," "2050 funds," etc.). Even though these funds are designed to benefit a certain age group for retirement, the variety of underlying funds and the overall risk associated with certain of these similarly-named funds varies greatly. For example, for a "2020 fund," one fund provider could use as few as 6 mutual funds to build the target date fund, while another fund provider could use 40 underlying funds. Furthermore, some of the biggest providers of target date funds use junk bonds or high-risk corporate bonds as a part of the underlying investments in the target date fund lineup. Most plan sponsors and participants do not realize the vast differences in how target date funds are constructed and packaged by the different fund providers that offer them.

Target date funds can be an effective investment tool when used properly. The problem is they are often offered by plan sponsors because they are approved by the DOL as a Qualified Default Investment Alternative (QDIA). Plan fiduciaries need to be aware of the various issues involved with offering *all* investment choices, including target date funds. A closer examination of some of the issues associated with target date funds will assist plan sponsors and fiduciaries in determining whether their 401(k) plans should offer target date funds, how they select these funds, and how they should educate their participants on these funds.

Qualified Default Investment Alternative (QDIA)

Regulations under the Pension Protection Act of 2006 provided plan sponsors with general fiduciary relief when using target date funds as a QDIA (*i.e.*, a fund or other vehicle into which a participant's account is invested when the participant fails to direct the plan where to invest his or her account). The primary benefits of a QDIA are (i) that offering it as an investment option will generally not subject plan fiduciaries to liability if a plan participant does not otherwise choose an investment and is defaulted to the QDIA offering and (ii) that the QDIA can be an investment used with automatic enrollment.

Many plan sponsors like the target date fund concept (and the fact that they are government-approved QDIAs) and have decided to offer the funds as part of the investment choices for their 401(k) plan. Plan participants subsequently invested in target date funds, expecting that as they approach retirement, they would be invested conservatively and would therefore preserve and grow their retirement accounts.

As fiduciaries, plan sponsors are still obligated to act "prudently" – neither QDIAs nor target date funds change this fiduciary requirement. In fact, the DOL guidance on QDIAs is clear that "*the fiduciary must prudently select and monitor the fund or portfolio or investment management service within any category of QDIA.*" Without evidence of prudent selection and monitoring of QDIA funds (including target date funds), plan sponsors can be exposed to significant fiduciary risk and may not have the fiduciary relief under the Pension Protection Act that they think they do.

To that end, plan sponsors must consider the facts and circumstances affecting their specific plan participants and select a QDIA option that best addresses those facts and circumstances in order to comply with the DOL's guidance on QDIAs. Target date funds are one possibility, but not the only QDIA option that must be considered. If target date funds are determined to be appropriate for the plan's participants, then the plan sponsor must conduct a thorough fiduciary evaluation of the available funds. At the very least, target date funds should be held to the same standards as the other investment options in a 401(k) plan's investment lineup. Furthermore, a plan sponsor should be willing to act appropriately when issues are identified with any plan investment option, QDIA or otherwise. Prudent monitoring requires a willingness to manage the QDIA options. This duty to monitor translates into a willingness to replace problem funds with alternative investments, if necessary.

Fiduciary Duties

Target date funds vary greatly from fund provider to fund provider in overall investment philosophy, underlying assumptions, glide path and what constitutes an appropriate portfolio for a given participant's anticipated retirement age. The fiduciary responsibility of plan sponsors for *selecting and monitoring* target date funds is the same as that applicable to the selection and monitoring of any other plan investments under ERISA.

To assist plan fiduciaries, the following is a list of relevant questions that should be considered when offering target date funds as plan investment options (as QDIAs and otherwise):

1. How is the investment performance of the target date fund as a whole and the individual investments that make up that fund? Are the fiduciaries reviewing appropriate benchmarks to evaluate and monitor all of the target date funds' performance?
2. What asset classes are used within the target date fund to achieve diversification? What is the glide path used by the target date fund (does the glide path end at retirement or continue for years beyond retirement)?
3. Who is the asset manager responsible for investing the assets in the target date fund and by whom is the asset manager's performance reviewed?
4. Are the target date funds in your plan aggressive or conservative when compared to all other target date funds? Are the assets invested in active or passive management? Are products being used institutional or retail?
5. Under what circumstances, if any, does the manager of the target date fund have discretion to vary from the stated asset classes, asset allocations and glide path that were originally provided to the fiduciaries when considering the use of the target date funds? Does the target date fund manager have discretion to replace underlying investments? Does the target date fund provide disclosure to the sponsor and/or participant when any such variations or changes occur?
6. What are the fees associated with the target date fund? Has the fund provider supplied clear and concise information about all of the fees to be charged? Are theses fees disclosed and understood by the fiduciaries? Has the fund vendor or provider repriced the fees since the target date funds were added to the investment lineup? Has the plan considered another provider of target date funds?

7. Does the target date fund provider supply any information to better educate participants about the way that the target date funds operate, including the makeup of the underlying investments and the fees associated with the funds?
8. Is the target date fund held to the same high standards as other investment options and are expenses deemed to be "reasonable" relative to similar investment options?
9. Is the risk of the QDIA appropriate for plan participants' needs? Can the target date fund as a QDIA offering be accurately assessed by plan fiduciaries with repeatable and reliable historical results?
10. Does the investment manager of the target date funds exhibit sufficient skill and care (and does such manager have no conflicts of interest) to merit the inclusion of the target date fund in the plan? (Please note that *if* the target date fund offered as a QDIA cannot meet the prudence requirements, then the plan sponsor should consider other QDIA options.)

Upcoming Guidance

The DOL and SEC are currently working on joint rules for employers and fund providers that offer target date funds as investment choices in their retirement plans.

The first piece of guidance has been released by the DOL and the SEC. This guidance is an "investor bulletin" that aims at raising awareness of how target date funds operate and the risks associated with target date investments. The document examines the significant differences in asset allocation strategies among various target date funds and could assist investors and plan participants to assess the appropriateness of including target date funds in their retirement portfolios. The bulletin can be found here:

http://www.dol.gov/ebsa/pdf/TDFInvestorBulletin.pdf

Future guidance likely will include both a *participant checklist* and a *fiduciary checklist* that will help to better educate those involved with target date funds and lead to greater transparency. The DOL and the SEC may also issue disclosure regulations that may require that certain information be provided to participants that are invested in target date funds, as well as disclosed to the government. We will be providing a detailed analysis of guidance regarding target date funds when it is released.

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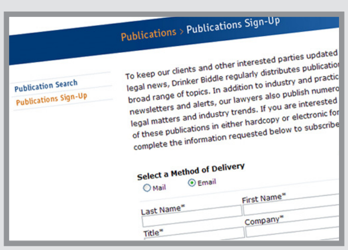

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