DOL Offers Tips on TDFs

Evaluating the demographics of a plan is key

AS OF THIS WRITING, the stock market is nearing all-time highs, and the share of 401(k) assets invested in target-date funds (TDFs) continues to increase, obscuring the troubling aspects of these plan investments exposed in the recent economic downturn. Many plan participants lack the time, ability or inclination to properly manage their investments; TDFs provide a simple means of obtaining the appropriate investment allocation and periodic rebalancing that results in an increasingly conservative asset mix as a participant nears retirement. The simplicity, however, is deceptive, and the nature of these funds—their fund-of-funds structure as well as their blueprint for changing the asset mix over time, known as the glide path—has fiduciary implications.

Fiduciary duties. 401(k) plan fiduciaries, like other retirement plan fiduciaries, are governed by the duty to act solely in the interest of participants and beneficiaries and to carry out their responsibilities "with the care, skill and diligence [of] a prudent man."

The Department of Labor (DOL) suggests that when comparing and selecting a TDF—and determining how well the investment aligns with the ages and likely retirement dates of participants—the fiduciary should examine the fund's prospectus, specifically its historical performance, fees and expenses, target date, glide path and the point at which the fund reaches its most conservative asset allocation, the so-called "landing point."

Beyond the prospectus, the DOL recommends that target-date fund providers be questioned on the impact that plan demographics—such as plan participation, salary levels, turnover rates and withdrawal patterns—will have on the investment. For example, if participants typically cash out shortly after retirement, it would be important for the fund to reduce its potential volatility at the landing point. For plans with participants who withdraw from the fund throughout retirement, the glide path landing point should be a number of years after the target date.

Periodic review. Noting that plan fiduciaries are required to periodically review a plan's investments to determine their continuing suitability, the DOL gives its strong view that the review should examine whether there have been any significant changes to the TDF's characteristics or the plan's objectives since the fund's original selection. Providers should be aware of changes in the management team or a shifting of the fund's investment strategy.

Understanding TDF investments. The DOL wants both plan fiduciaries and participants to understand the strategies and risks, not only of the TDF but also of its underlying investments and the asset classes into which they are divided.

Fees and expenses. An essential part of a fiduciary's duty is to determine whether an investment's fees and expenses are justified by its performance. For target-date funds, this includes their underlying funds. Thus, if the total expense ratio for the underlying funds is substantially less than the overall fees and expenses charged by the TDF, the fiduciary will ascertain the reason for the difference and seek justification.

Proprietary vs. nonproprietary funds. Many TDFs invest exclusively in affiliated mutual funds. The DOL recommends that a plan fiduciary ask the plan's investment provider if it can create a customized nonproprietary TDF consisting of the plan's existing core funds, as well as whether this would result in additional costs and administrative complexity.

Employee communications. The DOL requires plan fiduciaries to furnish participants with general information about TDFs, as well as details relating to the particular TDFs that are actually offered by the plan. Participants need this information to determine if a target-date fund would be a good fit for them. Moreover, the participant-level disclosure regulations that went into effect in 2012 require the delivery to participants of specific fee and expense information about TDFs.

Information sources. As a matter of prudence, if a plan fiduciary does not possess the necessary expertise to evaluate an investment, the fiduciary must seek outside advice or assistance, as necessary. The DOL notes that target-date funds are a relatively new investment option but that there are a number of commercially available sources of information and services relating to TDFs to assist fiduciaries in the review process.

Documentation. Finally, the DOL indicates that the selection and review process for a target-date fund should be documented, including how the fiduciary reached its decision to make a fund available.

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