

## Target Date Funds: What You Need to Look For

**F**or many employers and employees, the target date funds (TDFs) in their 401(k) plans can do no wrong. The concept of simply picking a fund which corresponds to your approximate retirement date, then leaving the asset allocation decisions to the professionals, has enormous appeal. But as a fiduciary to your plan that doesn't mean you're off the hook by simply offering whatever TDF line-up your fund provider

offers you.

The U.S. Department of Labor made that very clear.

**Background:** Callan Associates, the financial research and consulting firm, reports that in 2012 a majority of participant contributions (for the funds in their DC index) went into TDFs. They now account for 16 percent of defined contribution assets. "It is only a matter of time before target date funds claim the largest slice of the DC asset allocation pie," the firm reports.

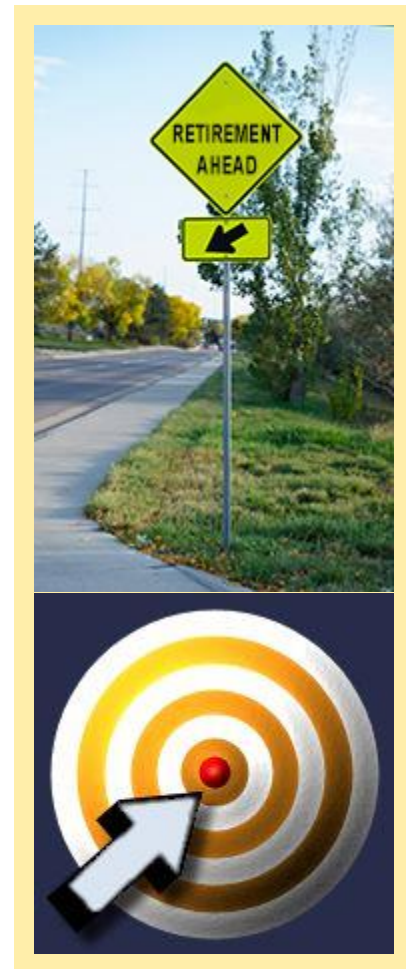
The Labor Department's Employee Benefits Security Administration warns that because fundamental variations among TDFs are so significant and impact performance, "it is important that fiduciaries understand these differences when selecting a TDF as an option for their plan."

Here's a summary of what the Labor Department wants employers and plan fiduciaries to do:

**Set a formal process for comparing and picking target date funds.** The process should enable you to assess the prudence of *any* investment option made available under the plan.

Beyond the basics of checking on how well the TDF's characteristics align with eligible employees' 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," according to the Department of Labor.

**Establish a process for the periodic review of selected TDFs.** Plan fiduciaries are required to periodically review the plan's investment options to ensure they should continue to be offered, the guidance states. "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." Sometimes a TDF's investment strategy or management team changes significantly. If that happens, and you don't like the change, "you should consider replacing the fund."



**What the Heck is a Glide Path?**

**Understand the fund's investments.** What are they, and how will they change over time? "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 TDFs assume employees will keep holding onto those TDFs for the rest of their lives, and others assume they will re-invest those funds when they reach retirement. "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 fees and investment expenses.** It should come as no surprise 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." (However, fees are not the sole determinant of net performance, of course.) "If the TDF invests in other funds, did you consider the fees and expenses for both the TDF and the underlying funds?" the Labor Department asks.

"Added expenses may be for asset allocation, re-balancing and access to special investments that can smooth returns in uncertain markets, and may be worth it, but it is important to ask."


**Consider whether a custom TDF would be a better fit for your plan.** The Labor Department notes that some TDF vendors use only their own funds as the TDF component investments. But a customized TDF may offer advantages by giving you the ability to incorporate the plan's existing core funds in the TDF. "Non-proprietary 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."

**Develop effective employee communications.** "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," the Labor Department stresses. Much of what employees must receive is already mandated, of course, such as fee disclosure rules that went into effect in August 2012. Those rules include specific fee and expense information about TDFs and other investment options available under their plans.

**Document the process.** As with other investment decisions, "plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options."

A complete version of the Department of Labor guidance can be found [here](#).

You may be familiar with the term "glide path," when it comes to flying. It refers to the descent of a plane, guided by a radar beam. The beam provides direction so that the plane lands safely at its intended destination.

As a plane is in the air it requires methodical adjustments over time -  - speed, direction, weather, proximity to the ground, geographical barriers like mountain ranges -- to ensure it reaches its intended destination.

The glide path of a TDF requires methodical adjustments in a similar way, becoming more conservative as the retirement date draws nearer. It may include a mix of assets that has a great deal of equity, for a longer, presumably smoother approach to the retirement date. Other TDFs might include a steeper trajectory, flying higher, with a bit more risk for a longer time, then becoming significantly more conservative when the landing is within sight.

For a plane or a target date fund, it's about the approach. How long is your horizon?