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Target Date Funds: Economic, Regulatory And Legal Trends

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Target date funds, or TDFs, are an increasingly important part of the retirement investment universe. These funds are often thought of as holding a mix of debt and equity investments, with the equity proportion declining according to a predetermined glide path. In reality, current TDFs are far more complex. New regulations, such as the U.S. Department of Labor's Fiduciary Rule, create uncertainties for TDFs going forward. Given these uncertainties and the sheer size of the TDF market, the current docket of TDF-related litigation is likely to grow.

What is a Target Date Fund?

In most cases, a TDF is a fund of funds designed to dynamically allocate across a variety of investment classes based on designated target retirement dates.[1] A TDF's portfolio composition is set and adjusted by a fund manager primarily based on one key factor: the target date.[2]

Asset Allocation

TDFs are generally designed to take on a more conservative risk posture as the target date is approached or passed. This is because investors who are nearing or are already in retirement are generally viewed as being less willing to bear significant downside risk. Typically, the portion of a portfolio invested in equity is reduced as the target date approaches.[3]

A typical equity investment carries higher financial risk and higher average returns than, for example, a high quality debt security, which contractually requires defined payments and is higher in a company's capital structure than equity.[4] Table 1 compares the average returns and variability of returns for large capitalization stocks to those of intermediate-term government bonds.

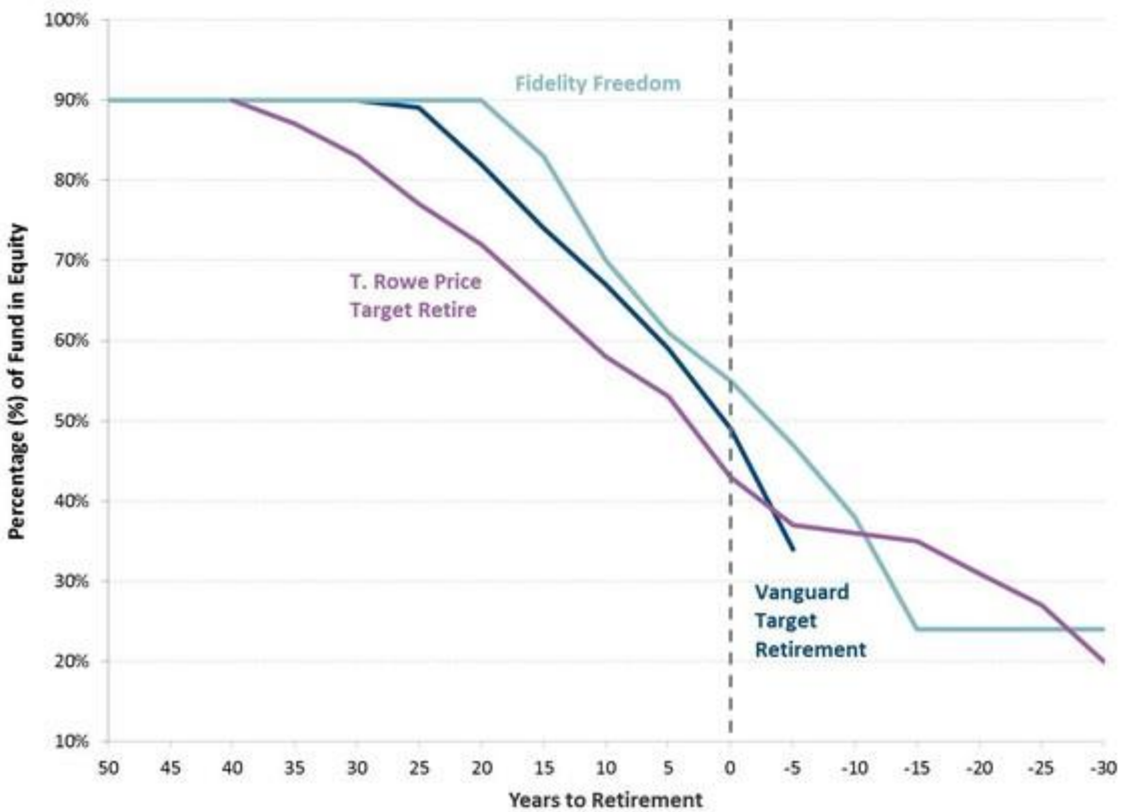
Table 1: Average Monthly Investment Returns and Standard Deviation, 1945 – 2015

	Mean Total Return	Standard Deviation of Returns
Large Capitalization Stocks	0.97%	4.17%
Intermediate-Term Government Bonds	0.45%	1.36%

Notes and Sources: Roger G. Ibbotson, 2016 SBBI Yearbook: Stocks, Bonds, Bills, and Inflation: U.S. Capital Market Performance by Asset Class 1926–2015 (Hoboken, New Jersey: John Wiley & Sons, Inc., 2016), Appendices A-1 and A-10. Calculations are done by Brattle.

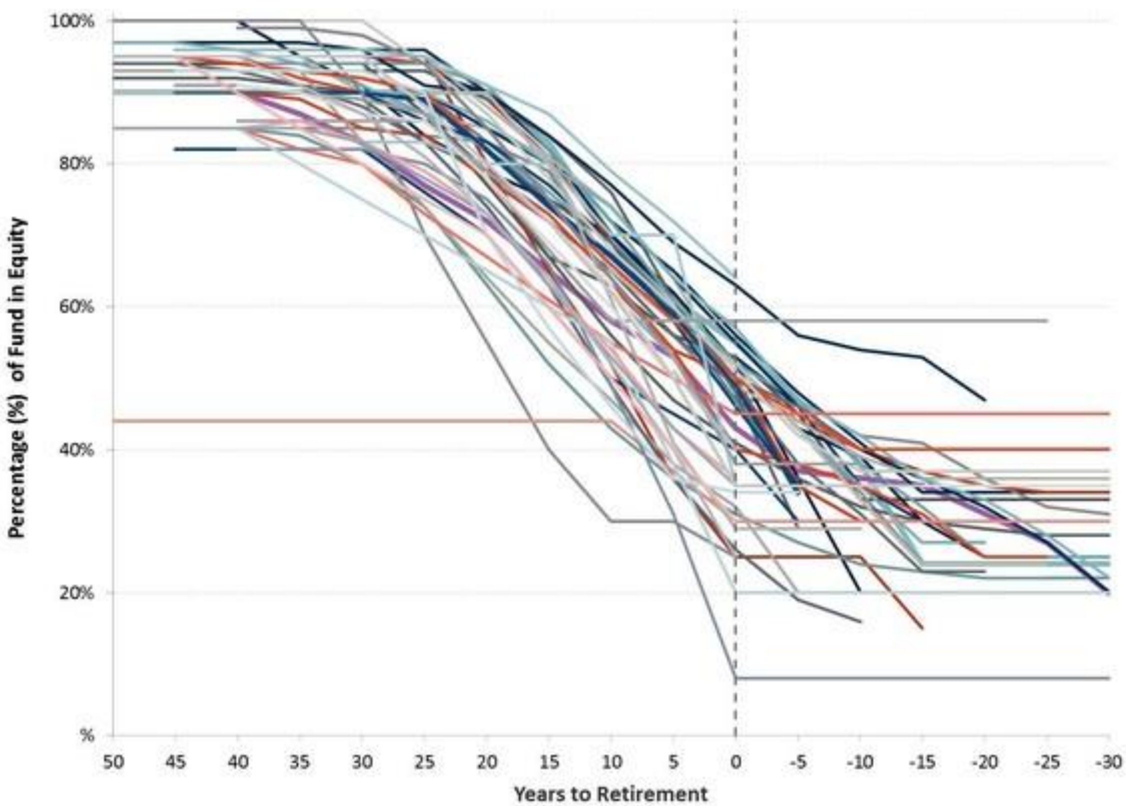
Reduction in equity exposure over time, commonly referred to as the “equity glide path,” is generally supported as a risk-reducing mechanism by historical performance statistics of asset classes,[5] but may vary widely between management companies. The targeted equity glide paths of the largest three TDF management companies are compared in Figure1 below, while Figure 2 depicts the glide paths of a wider range of TDF offerings.

Figure 1: Glide Paths of Top Three TDF Providers



Source: Jeff Holt et al., “2016 Target-Date Fund Landscape,” Morningstar, April 12, 2016, Appendix 2, “Complete Glide-Path Equity Allocations by Target-Date Series %,” pp. 83-84.

Figure 2: Glide Paths of Various Funds

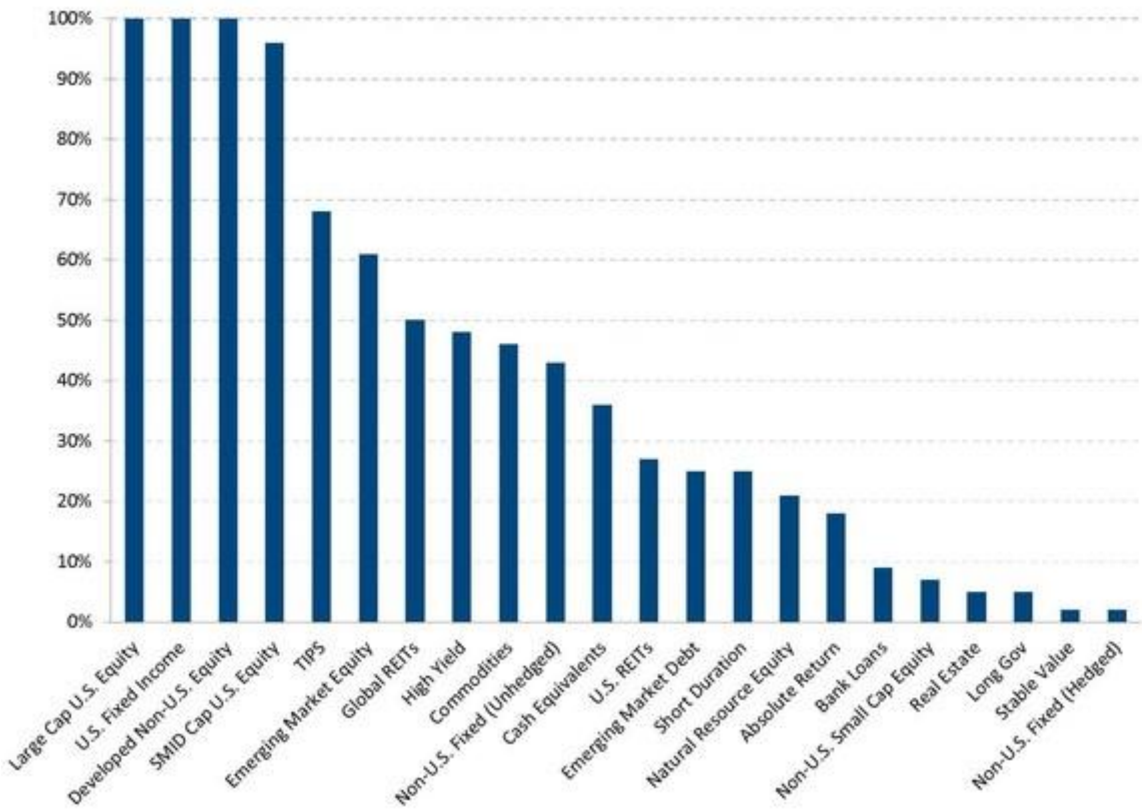


Source: Jeff Holt et al., “2016 Target-Date Fund Landscape,” Morningstar, April 12, 2016, Appendix 2, “Complete Glide-Path Equity Allocations by Target-Date Series %,” pp. 83-84.

TDF products may also vary widely in the degree of leeway permitted for “tactical allocations” away from listed target allocations.[6] Fund managers may opt to avoid transaction costs associated with perfect rebalancing, but may also deviate from specified targets opportunistically. For example, in a rapidly rising equity market, a TDF with a 90 percent equity target and sufficient tactical leeway might instead shift to 100 percent equity. While studies show that the broader asset allocation decisions determine a large portion of fund return differences,[7] competitive pressures may incentivize TDF managers to chase unwisely more immediate returns.

As shown in Figure 3, the number of investment classes utilized by TDFs has grown well beyond traditional long positions in debt and equity investments, with increasing prevalence of specialized assets such as emerging markets, real estate and commodities, which are utilized to diversify from equity and debt and also as an inflation hedge.[8] However, research suggests “over diversification” may have a negative impact on fund of funds returns.[9]

Figure 3: Prevalence of Various Asset Classes across Glide Paths



Source: James Veneruso, "Target Date Funds: Finding the Right Vehicle for the Road to Retirement," Callan Investments Institute, September 2015, Exhibit 7, "Prevalence of Various Asset Classes Across Glide Paths," p. 6, accessed June 20, 2017, https://www.callan.com/wp-content/uploads/2017/02/Callan-TDF.pdf.

Asset architecture presents another layer of variation between TDF products. Managers operating with a "closed architecture" only purchase underlying funds managed by their own fund management company (e.g., a Vanguard TDF might invest only in Vanguard equity and bond funds). Conversely, an "open architecture" approach allocates some investments to funds offered by third-party fund management companies.

These layers of variation result in significant heterogeneity in the risk and return characteristics of different TDFs.[10] During the financial crisis that began in 2007, TDFs with the same target date exhibited striking differences in annual returns. In Table 2, we document the dispersion in TDF returns for several funds with target dates within 15 years of the financial crisis. Funds experienced, to different degrees, large declines in value in 2008 followed by large percentage gains in 2009, resulting in varying four-year annualized returns.

Table 2: Returns of Selected TDFs, 2007 – 2010

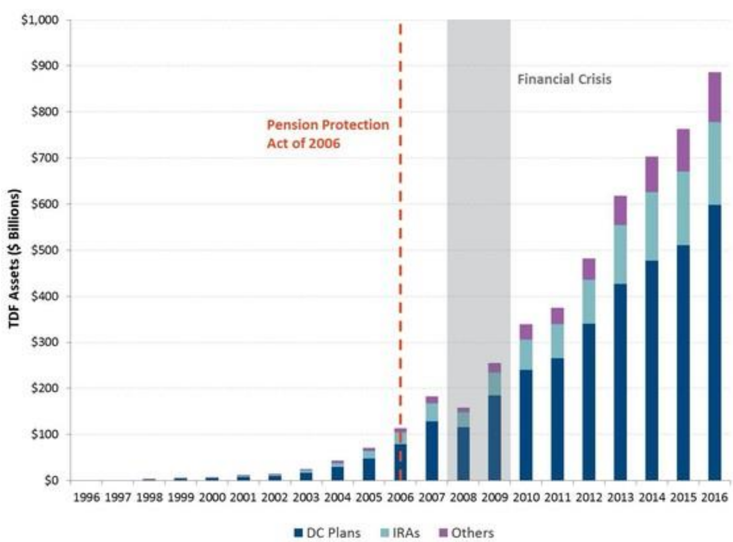
	2007	2008	2009	2010
2010 Funds				
Fidelity Freedom 2010 Fund	7.4%	-25.3%	24.8%	11.7%
Vanguard Target Retirement 2010 Fund	7.7%	-20.7%	19.3%	11.4%
T. Rowe Price Target 2010 Fund	6.7%	-26.7%	28.0%	12.7%
Wells Fargo Dow Jones Target 2010 Fund	6.9%	-11.0%	12.6%	8.8%
2015 Funds				
Fidelity Freedom 2015 Fund	7.8%	-27.2%	25.6%	11.8%
Vanguard Target Retirement 2015 Fund	7.6%	-24.1%	21.3%	12.5%
T. Rowe Price Target 2015 Fund	6.8%	-30.2%	31.4%	13.8%
Wells Fargo Dow Jones Target 2015 Fund		-16.5%	15.8%	10.0%
2020 Funds				
Fidelity Freedom 2020 Fund	8.5%	-32.1%	28.9%	12.9%
Vanguard Target Retirement 2020 Fund	7.6%	-27.0%	23.1%	13.1%
T. Rowe Price Target 2020 Fund	6.7%	-33.5%	34.2%	14.7%
Wells Fargo Dow Jones Target 2020 Fund	7.3%	-22.1%	19.2%	11.5%

Notes and Sources: Bloomberg and Morningstar. Returns shown are historical total returns based on the net asset value ("NAV") of each fund.

Growth Trends and Drivers

TDF assets have seen extraordinary growth over the past decade and currently exceed $1 trillion.[11] The Investment Company Institute reported that as of December 2016, there were $887 billion in TDF mutual fund assets (see Figure 4) and estimated that TDF assets held solely within reported defined contribution plans (including 401(k)s) and IRAs totaled approximately $778 billion, approximately 12 times the level reported at year-end 2005.[12]

Figure 4: Target Date Mutual Fund Assets ($ Billions)



Source: “Report: The U.S. Retirement Market, Fourth Quarter 2016,” Investment Company Institute, March 2017, Table 21, “Target Date Mutual Fund Assets,” accessed June 15, 2017, https://www.ici.org/info/ret_16_q4_data.xls.

A few key drivers have spurred growth in TDFs assets. The first is a shift by employers away from defined benefit plans (e.g., pension plans) to DC plans. By 2005, DB plans were offered by less than half of Fortune 500 companies, and by 2015, under 20 percent.

TDF assets have also grown significantly relative to other investment options. A Plan Sponsor Council of America survey reported that TDF assets comprised approximately 19.8 percent of 401(k) participant assets in 2015,[13] ranking second amongst all fund types, an increase from 12.4 percent in 2011.[14] One research firm has predicted that by the end of 2019, 88 percent of all new 401(k) contributions will be directed into TDFs.[15]

The Pension Protection Act of 2006 served as the most significant catalyst for increasing allocation of investments into TDFs. The qualified default investment alternative, or QDIA,[16] provisions under the PPA 2006 permitted fiduciary liability risk under ERISA to be managed by directing unallocated employee DC contributions into a default alternative or “safe harbor” investment class,[17] and explicitly identified TDFs as such an option.[18] Fund administrators had previously directed most unallocated employee investments into money-market mutual funds or other ultra-safe funds. A significant portion of DC contributions are now automatically directed into TDF funds.[19] According to Vanguard, where plans designated a QDIA in 2015, 95 percent designated a TDF,[20] compared to 80 percent in 2009.[21]

Emerging TDF Fiduciary Issues

Fiduciary Rule under ERISA

The Employee Retirement Income Security Act sets out various standards required of DC plan “fiduciaries,” defined in functional terms of control and authority over the plan. DC plan fiduciaries normally include plan trustees, plan administrators, members of a plan’s investment committee, or anyone who provides investment advice to a plan for compensation.[22]

A fundamental fiduciary duty under ERISA is the duty of “care, skill, prudence, and diligence” that a prudent man would exercise under similar circumstances — sometimes known as the prudent man rule.[23]

Though TDFs are designated as a “safe-harbor” investment type under the PPA 2006, plan administrators continue to have fiduciary responsibilities as to selection of a particular TDF product. Because the investment manager of an externally sourced TDF is generally not a plan fiduciary,[24] DC plan sponsors retain responsibility to evaluate relevant aspects of TDFs in relation to the plan’s goals, considering TDF performance, fees and expenses.[25]

This is demonstrated in Tussey v. ABB Inc.,[26] in which fiduciaries were found to violate ERISA by failing to consider adequately the reasonableness of fees charged by the fund record-keeper.[27] Similarly, in Meiners v. Wells Fargo & Company, the plaintiffs alleged violation of fiduciary duties of loyalty and prudence under ERISA due to their investment “of Plan assets … into Wells Fargo’s own proprietary [TDF] funds,”[28] which are claimed to “cost on average over 2.5 times more than comparable target date funds while …substantially and consistently underperforming those comparable funds.”[29]

In Jacobs v. Verizon Communications Inc., the plaintiffs alleged violation of fiduciary duties in the selection of an employee retirement plan that "added a second layer of investment management fees"[30] by investing into TDFs that included certain "specialty" asset classes in their asset allocation, which "added significant levels of risk and complexity"[31] that made the funds "overly complex, overly risky, and inappropriate for the average Verizon employee."[32] A similar breach is charged in Sulyma v. Intel Corporation Investment Policy Committee, in which plaintiffs challenged the "prudence" of the fiduciaries' decision to seek optimal returns while protecting against equity market volatility[33] by investing in more costly actively managed strategies.[34] The plaintiff argued that these "asset allocation models … departed dramatically from prevailing standards" and presented "unconventional, significant and undue risks and unduly high fees and costs."[35]

These cases demonstrate potential tension between the "prudence" responsibilities and "diversification" responsibilities imposed on fiduciaries under ERISA. If the prudence standard is interpreted as requiring plan fiduciaries to select TDFs with similar risk, cost, and return characteristics to those selected by most other seemingly prudent plan fiduciaries, this increases the legal and compliance risk of using potentially superior TDF strategies. A TDF designed to avoid downside risk by sacrificing upside or through increased diversification may provide superior "through the cycle" performance while opening DC fiduciaries to criticism for their selection of a high-cost, and therefore "imprudent," outlier fund.

DOL's Fiduciary Rule

While ERISA applies fiduciary standards to any party with control or authority over an employer sponsored retirement plan,[36] the DOL's fiduciary rule effectively applies a fiduciary standard to registered representatives who provide recommendations on non-ERISA retirement investment accounts, such as IRAs.

Broadly, the fiduciary rule moves broker-dealers and affiliated RRs from the less strict "suitability" standard to a fiduciary "best interest" standard, with respect to their investment recommendations on non-ERISA retirement accounts. An example of a previously acceptable TDF recommendation potentially failing the new best interest standard would be the purchase of a generally suitable TDF over a virtually identical, but less expensive, alternative.[37]

Analyses of value versus cost of a TDF may be complex and multifaceted, however. If a more expensive investment option provides relatively poor performance, this does not imply that it was a suboptimal choice. The selection process and periodic reassessment are critically important, given that future returns are unknowable. Important features such as investment manager experience, risk management systems and hedging strategies may only demonstrate their benefits during time periods exhibiting turbulent markets, for example.

Initial reports indicate that the new fiduciary rule has led to reductions in brokerage account types in which customers are charged on transactions and where brokers are typically compensated through sales commissions — leading to potential conflicts of interest. Conversely, non-commission accounts such as fee-based accounts and self-directed brokerage accounts have increased.[38]

The DOL's fiduciary rule has the potential to result in a significant number of lawsuits under the new private right of action for investors. Given that wide variation will lead to significant performance differences across TDFs, purchase recommendations for a specific TDF investment may give rise to lawsuits if the TDF realizes lower returns than other options. Brokerage firms should therefore mitigate their legal risk by maintaining documentation as to why a particular TDF was viewed at the time to be in the best interest of the client.

Given the long-term nature of TDFs and potential litigation that may be sparked by the fiduciary rule, the quantification and valuation of proper risk management, experience and other less tangible factors is likely to become an increasingly important area of expertise for fiduciaries and experts.

Conclusion

The size, heterogeneity and complexity of the TDF market have clearly increased over recent years. This backdrop along with the evolving regulatory frameworks and legal decisions make TDFs an important area to monitor going forward.

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[1] Some TDFs are designed to be used for 529 Plan education savings programs, and thus their target dates aren't retirement-based.

[2] As with any U.S. open-end mutual fund, objectives and constraints of the fund are described in the offering documents.

[3] Some TDFs only adjust fund allocations up "to the target date," while others adjust allocations "through the target date."

[4] In terms of corporate capital structure, bond payments have priority over equity.

[5] Despite the baseline points, it should be clear that not every portfolio with less equity should be considered less risky than one with more equity and vice versa.

[6] See, e.g., Dynamic Target Date Funds Prospectus for Class R6, Wells Fargo Asset Management, October 1, 2016, p. 22, accessed May 23, 2017, https://www.wellsfargofunds.com/assets/edocs/regulatory/prospectus/dynamic-target-date-r6-pro.pdf. ("At their discretion, the Fund's portfolio managers may make changes to the Fund's asset allocation. At any point, as a result of the utilization of the futures overlay and changes otherwise implemented by the portfolio managers, there may be significant divergences between the effective asset allocation of the Fund and its strategic target allocation.")

[7] See, e.g., Robert G. Ibbotson and Paul D. Kaplan, “Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?” Financial Analysts Journal 56(1) (January/February 2000): 26-33, accessed July 12, 2017, http://www.mangustarisk.com/doc/pdf/Does_Asset_Allocation_Explain_40_90_100_Performance.pdf.

[8] See Edwin J. Elton, Martin J. Gruber, Andre de Souza, and Christopher R. Blake, “Target Date Funds: Characteristics and Performance,” Review of Asset Pricing Studies 5(2) (December 2015): 258-260; “TIAA-CREF Lifecycle Funds: Methodology and Design,” TIAA Global Asset Management, 2017, Exhibit 1: “TIAA-CREF Lifecycle Funds Glidepath,” p. 2, accessed May 22, 2017, https://www.nuveen.com/Home/Documents/Default.aspx?fileId=67235; Edwin J. Elton, Martin J. Gruber, Andre de Souza, and Christopher R. Blake, “Target Date Funds: What’s Under the Hood?,” Center for Retirement Research at Boston College, 17(2) (January 2017), p. 2, accessed May 22, 2017, http://crr.bc.edu/wp-content/uploads/2017/01/IB_17-2.pdf.

[9] Stephen J. Brown, Greg N. Gregoriou, and Razvan C. Pascalau, “Diversification in Funds of Hedge Funds: Is It Possible to Overdiversify?,” July 7, 2011, accessed July 12, 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1436468.

[10] “Fact Sheet: Morningstar Target-Date Fund Series Rating and Research Reports,” Morningstar, 2009, p. 1, accessed June 15, 2017, https://admainnew.morningstar.com/directhelp/FactSheet_TargetDateRating.pdf.

[11] See, e.g., “Target-Dates Top $1 Trillion, Yet Remain Largely Out of Reach for Most Asset Managers,” Sway Research press release, March 22, 2016, accessed April 2, 2017, https://static1.squarespace.com/static/5661aba4e4b0c3b0ea70a07a/t/56f3ee4f20c647752991f97b/1458826848955/State_of_T-D_Market_Mar_2016.pdf.

[12] “Retirement Assets Total $25.3 Trillion in Fourth Quarter 2016,” Investment Company Institute, March 22, 2017, accessed June 15, 2017, https://www.ici.org/research/stats/retirement/ret_16_q4 and “2017 Investment Company Fact Book,” 57th edition, Investment Company Institute, Figure 7.25, “Target Date and Lifestyle Mutual Fund Assets by Account Type,” p. 161, accessed June 15, 2017, https://www.ici.org/pdf/2017_factbook.pdf.

[13] See “PSCA Releases Results of 59th Annual Survey of Profit Sharing and 401(k) Plans,” PCSA press release, December 19, 2016, accessed May 19, 2017, https://www.psca.org/psca-releases-results-of-59th-annual-survey-of-profit-sharing-and-401-k-plans. “PSCA’s 59th Annual Survey reflects the 2015 plan-year experience of 614 DC plan sponsors.” According to this press release, TDF assets (which made up 19.8 percent of respondents’ 401(k) assets) were second only to “actively managed domestic equity funds,” which comprised 21.4 percent of respondents’ 401(k) assets.

[14] See “PSCAs Annual Survey Shows Company Contributions are Bouncing Back,” PCSA press release, October 11, 2012, accessed May 22, 2017, https://www.psca.org/psca-s-annual-survey-shows-company-contributions-are-bouncing-back.

[15] See, e.g., “Customization Comes to Target-Date Funds,” CPA Client Bulletin, September 2016, accessed February 6, 2016, http://www.danielratliff.com/wp-content/uploads/2016/11/AICPA-Client-Newsletter-September-2016.pdf; see also Robert Steyer, “Cerulli: Target-Date Funds Snagging Larger Share of 401(k) Assets,” Pensions & Investments, November 24, 2014, accessed May 22, 2017,

http://www.pionline.com/article/20141124/ONLINE/141129936/cerulli-target-date-funds-snagging-larger-share-of-401k-assets.

[16] See 29 CFR § 2550.404c-5 ("Fiduciary relief for investments in qualified default investment alternatives").

[17] Automatic enrollment for 401(k) plans has existed since at least the 1990s and has become increasingly more common in recent years since the passage of the PPA 2006, which encourages the use of automatic enrollment in 401(k) plans. It is not uncommon that employee DC plan investors, particularly auto-enrollees, fail to specify an investment allocation, leaving them with the default allocation and contribution rates set by the sponsor. See Jack VanDerhei, "The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors," Employee Benefit Research Institute, No. 341, April 2010, pp. 4 and 6, accessed August 2, 2017, https://www.ebri.org/pdf/briefspdf/EBRI_IB_04-2010_No341_Auto-Enroll1.pdf. "Employers can choose to automatically enroll employees in 401(k) plans, choosing a default initial contribution rate and a default investment, unless the employee indicates otherwise." See "The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2014," BrightScope and Investment Company Institute, December 2016, pp. 17-18, accessed February 6, 2017, https://www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf. According to Aon Hewitt, in 2010 approximately 57 percent of DC plans automatically enrolled new employees, up from 24 percent in 2006. See "2011 Hot Topics in Retirement: A Changing Horizon," Aon Hewitt, p. 10, accessed April 2, 2017, http://www.aon.com/attachments/thought-leadership/2011%20Hot%20Topics_Final.pdf.

[18] Only two other types of investments are deemed default investments in which unallocated funds can be directed and invested indefinitely. See, e.g., DOL Employee Benefits Security Administration, "Automatic Enrollment 401(k) Plans for Small Businesses," November 2013, p. 5, accessed May 22, 2017, https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/addingautoenroll.pdf.

[19] See "How America Saves 2016: Vanguard 2015 Defined Contribution Plan Data," Vanguard, June 2016, p. 58, accessed May 17, 2017, https://pressroom.vanguard.com/nonindexed/HAS2016_Final.pdf.

[20] Ibid.

[21] See "How America Saves 2014: A Report on Vanguard 2013 Defined Contribution Plan Data," Vanguard, June 2014, Figure 1, "Highlights at a glance," p. 6, accessed June 20, 2017, https://institutional.vanguard.com/iam/pdf/HAS14.pdf.

[22] See, e.g., "Fiduciary Responsibilities," U.S. Department of Labor, accessed May 23, 2017, at https://www.dol.gov/general/topic/retirement/fiduciaryresp. (Fiduciary duties are owed under ERISA by "persons or entities who exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so are subject to fiduciary responsibilities" including "plan trustees, plan administrators, and members of a plan's investment committee.")

[23] See ERISA § 404(a)(1)(B), codified at 29 U.S. Code § 1104(a)(1)(B).

[24] See U.S. Department of Labor, Employee Benefits Security Administration, Advisory Opinion 2009-

04A, December 4, 2009, p. 2, accessed June 6, 2017, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/2009-04a; see also "Fiduciary Guidebook for Target Date Funds," Wagner Law Group, Legg Mason Global Asset Management, 2011, p. 4, accessed May 23, 2017, http://www.wagnerlawgroup.com/documents/WPFiduciaryGuidebooktoTDFs.pdf.

[25] "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries," U.S. Department of Labor, Employee Benefits Security Administration, February 2013, p. 2, accessed May 23, 2017, https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf.

[26] Tussey v. ABB, Inc., 746 F.3d 327 (8th Cir. Mar. 19, 2014).

[27] Id. at 341.

[28] Complaint, ¶¶ 1-2, Meiners v. Wells Fargo & Co., 2017 U.S. Dist. LEXIS 80606 (D. Minn. May 25, 2017) (No. 16-cv-03981).

[29] Id. at ¶ 3.

[30] Complaint, ¶ 9, Jacobs v. Verizon Comm., Inc., No. 16-cv-01082 (S.D.N.Y. February 11, 2016) at ¶ 14.

[31] Id. at ¶¶ 17-18.

[32] Id. at ¶ 9.

[33] Memorandum of Points and Authorities, p. 1, Sulyma v. Intel Corp. Inv. Policy Comm., 2017 U.S. Dist. LEXIS 49788 (N.D. Cal. Mar. 31, 2017) (No. 15-cv-04977).

[34] Ibid.

[35] See Consolidated Complaint, ¶ 1, Sulyma v. Intel Corp. Inv. Policy Comm., 2017 U.S. Dist. LEXIS 49788 (N.D. Cal. Mar. 31, 2017) (No. 15-cv-04977).

[36] "General Information on the Regulation of Investment Advisors," U.S. Securities and Exchange Commission, March 11, 2011, accessed July 17, 2017, https://www.sec.gov/divisions/investment/iaregulation/memoia.htm.

[37] Carmen Germaine, "SEC Muddies Fiduciary Rule Waters With Comment Request," Law360, June 7, 2017, accessed June 20, 2017, https://www.law360.com/banking/articles/932214/sec-muddies-fiduciary-rule-waters-with-comment-request.

[38] Lisa Beilfuss, "'Fiduciary' Rule Accelerates Account Shift Across Brokerage Industry," The Wall Street Journal, July 19, 2017, accessed July 27, 2017, https://www.wsj.com/articles/fiduciary-rule-accelerates-account-shift-across-brokerage-industry-1500494055.