NORTHERN TRUST
ASSET MANAGEMENT

HOW TO VET TARGET DATE FUNDS

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Target date funds (TDFs) differ significantly in terms of asset classes, glidepath, fulfillment, and fees. It is a rich variety to choose from and at the same time may add to one's perplexity. So, how do plan sponsors evaluate a TDF series?

We briefly discuss the lessons from a few participant-initiated lawsuits, the predictability of fund performance based on ratings, and the tips from the Department of Labor (DOL). The tips set up a framework that seeks to align investment strategies with employee demographics. Summarily, plan fiduciaries should define investment strategies based on the plan's objectives and evaluate the asset managers' process to meet these stated objectives. Fund performance and fees, which are certainly important and often receive the lion's share of focus for many fiduciaries, should not be the only factors that dictate the evaluation and retention of a target date fund.

LESSONS FROM LAWSUITS

Tibble v. Edison International

The plaintiffs alleged that Edison International's financial advisors and investment committee breached their fiduciary duties for not switching mutual funds from retail to institutional shares. The U.S. District Court in California in 2017 ruled in favor of the plaintiffs.

This ruling has applied the now-famous "distinct duty to monitor" standard that was set forth by the Supreme Court a few years ago. By the Supreme Court's decision, plan sponsors have a continuing duty to monitor investments in retirement plans and remove imprudent ones, which is separate and distinct from the duty to exercise prudence in the initial choice of an investment.

Jacobs v. Verizon Communications, Inc.

A participant in a Verizon retirement plan alleged that the underlying funds and multiple layers of fees "are nearly impossible for participant in Verizon's plans to understand or evaluate." The lawsuit specifically called out target-date funds offered in the plans and alleged that they underperformed low-fee, passively managed funds offered by Vanguard.

The U.S. District Court in New York found the plaintiff's claims to be insufficient. According to the court, first, the DOL requires target date funds to offer a broad range of investment alternatives with diversified risk-return characteristics without the requirement to take into account risk tolerances or preferences of an individual participant; second, the plaintiff failed to demonstrate Vanguard's superior performance; and finally, there was no allegation that "the defendants selected certain funds out of self-interest or demonstrated clear incompetence."

Meiners v. Wells Fargo & Company

The plaintiff alleged that the Wells Fargo plan violated the Employee Retirement Income Security Act (ERISA) because the Wells Fargo target-date series performed worse than one offered by Vanguard Group and charged higher fees than ones offered by Vanguard or Fidelity.

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The U.S. District Court in Minnesota dismissed the lawsuit in favor of Wells Fargo 401(k) plan. The judge ruled that "a comparison of the returns of two different funds is insufficient" to demonstrate a fiduciary duty breach, on the premise that the two target-date portfolios "perform differently because the Wells Fargo funds have a different investment strategy," including a higher allocation to bonds than other TDFs. Also, the judge said "fees, like performance, cannot be analyzed in a vacuum" and "failure to invest in the cheapest fund available does not necessarily suggest a breach of fiduciary duty."

There are two key takeaways from these legal cases:

- Selection and ongoing monitoring of target date funds should include evaluation of performance and fees, but they should not be the only two factors.
- Incorporation of a review of the fit based on the alignment with overall plan objectives and participant demographics is critical in the monitoring process.

MANAGER SELECTION BASED ON RATINGS

Can you select an asset manager based on a third party's ratings?

Wall Street Journal (WSJ) had this headline: "investors everywhere think a 5-star rating from Morningstar means a mutual fund will be a top performer – it doesn't."[1] WSJ found that only a fraction of those funds that were awarded a top rating performed well enough over the next five years to maintain that rating; some performed so poorly that they ended up with a rock-bottom one-star rating. Morningstar defended its analytical value by saying that five-star funds tended to maintain higher ratings than four-star funds over the time period studied, and so on, which is "tilting the odds in investors' favor."[2]

The debate thus continues. In the context of academic research, WSJ's investigation isn't pioneering but it reminds investors that past performance is no guarantee of future outcomes.

SELECTION OF STRATEGIES BASED ON OBJECTIVES AND PROCESS

The DOL offers helpful tips for the selection and monitoring of target date funds and suggests plan fiduciaries do the following:[3]

1. Establish a process for comparing and selecting target date funds,
2. Establish a process for the periodic review of target date funds,
3. Understand the fund's investments,
4. Review the fund's fees and investment expenses,
5. Inquire about custom or non-proprietary target date funds,
6. Develop effective employee communications,
7. Take advantage of available sources of information, and
8. Document the process

The DOL document is a good source of information and education for plan sponsors and fiduciaries. The tips are worth a careful read. We offer some additional thoughts below.

It is clear that, from these tips, fiduciaries need to define objectives they expect to achieve for the plan constituents. This is by no means equivalent to seeking returns to beat an exogenous (or often irrelevant) index benchmark. Rather, there has been a shift of focus towards

[1] The Wall Street Journal, "The Morningstar Mirage," October 25, 2017.
[2] Morningstar, "A Message from the CEO," October 25, 2017.
[3] Department of Labor, 2013, "Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries."

generating adequate retirement income for participants. The objectives should be in line with participants' demographic and economic characteristics. Their specific retirement goals can be calibrated by analytical tools and should be reflected in investment strategies.[4] The fit should therefore be judged by how well the portfolios will fund such expected liabilities (spending needs in retirement) and whether the risk-taking is measured and not excessive.[5]

Given the continuing duty to monitor investments, fiduciaries need to review changes in philosophy and management of the investment provider. Likewise, changes in plan provisions and population (as induced by mergers and acquisitions, for instance) are opportune times for fiduciaries to revisit the suitability of strategies.

Plan sponsors will quickly notice that there are multiple glidepaths for them to choose from, including different categorizations of asset classes, aggressive, moderate, vs. conservative asset allocations, and "to" vs. "through" retirement. It is critical to think through the reasons behind the design. For instance, does the glidepath have sufficient diversification? Does it reflect workers' varying risk-taking capacities and appetites at different life stages? Is it appropriate for workers to go with the most aggressive equity exposure at the onset of their careers?

Not necessarily. Younger investors in general have a higher capacity to afford risk, on the premise that time is on their side and future earnings serve as a cushion for shocks, but they report a lower appetite to do so. U.S. millennials under age 30 were more likely to describe themselves as conservative investors than as aggressive; Australia's "next generation" investors were more risk averse than the older workers.[6]

Taking both theory and behavior into account, Northern Trust offers a target date strategy that is designed to mitigate investor sensitivity to market fluctuations among younger workers and accelerate wealth accumulation when their capacity and appetite combined has the strongest accommodation for growth around mid-career.[7]

Fees are a major theme for DC plans. Litigation risk adds to fear. Discussions are often anchored there and overshadow a holistic view of success factors for a retirement plan. However, an average worker's wealth upon retirement could be primarily attributable to persistent

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[4] Northern Trust, 2017, "How Much Retirement Savings Is Enough?"
[5] Northern Trust, 2017, "What's the Funding Status of your DC Plan?"
[6] Cerulli Associates, Rethinking Risk for U.S. Millennials, 2017; Deloitte, ASX Australian Investor Study, 2017.
[7] Northern Trust, 2017, "Glidepath Innovation to Drive Better Participant Outcomes."

savings (68%) and investment outcomes (38%), while a portion (6%) could be chopped off by fees, which is perhaps a significantly smaller erosion than many feared.[8]

The DOL says “don’t consider fees in a vacuum.”[9] The U.S. District Court in Minnesota nodded. Low-cost mandate should not simply morph into easier-to-implement asset classes, less professional expertise and services, or insufficient diversifications among key areas and markets.

A common critique of off-the-shelf TDFs is that the one-size-fits-all approach may no longer be appropriate if the plan has a population of heterogeneous investors. Plan sponsors in this case may wish to consider customizing the solution at the plan level or personalizing it for each individual. Retirement savings and investing are complicated and evolving, while workers’ financial literacy and skills are limited in general. This calls for help from an investment manager who understands participant behavior to develop solutions (including effective communications) and nudge workers towards better outcomes. More spot-on services and advice would be provided and customized or personalized strategy could be a better fit for the plan.

A savvy asset manager would also assist the plan fiduciaries to document plan goals, investment policy, due diligence, and ongoing monitoring efforts. This is best practice and keeps evolving investment committee members educated and informed with all the careful considerations and reasons behind decisions.

CONCLUSIONS

Fund performance alone is not a sufficient prerequisite for retirement plans to select or reject a fund manager; fees are important but should not supersede other considerations either, as indicated by the DOL tips and court rulings. Rather, plan fiduciaries need to define their plan objectives and establish a process to evaluate, select and monitor investment strategies.

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Granular things aside, sound plan governance clearly stood out as the critical determination of fiduciary competency. This encompasses a prudent decision-making and selection process, avoidance of self-interest, and continued monitoring, in order to ensure that fund options are appropriate for the retirement plan.

[8] Pang, Gaobo. 2016. “Fear of Fees in Defined Contribution Plans.” *Journal of Financial Planning* 29 (7): 46–51.
[9] U.S. Department of Labor. August 2013. “A Look At 401(k) Plan Fees.”

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NORTHERN TRUST ASSET MANAGEMENT

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Our forward-looking, historically aware investment approach powers a broad range of capabilities and solutions. And our comprehensive asset class offering includes passive, factor-based, fundamental active and multi-manager solutions that are available in a variety of investment vehicles.

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[10] Represents total assets managed by the subsidiaries of the Northern Trust Corporation (as of December 31, 2018)