TARGET DATE FUND CONSIDERATIONS FOR 457 PLANS

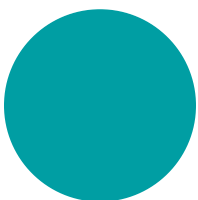
Target Date Funds (TDFs) are a simple, popular, fee-conscious way to invest one's retirement account to ensure a layman investor does not "mess up" their retirement investment. TDFs are portfolios that are designed to automatically become more conservative over the life of the investor until the estimated "target date" of retirement when one's portfolio should be relatively conservative. While there are many ways that TDF managers try to distinguish their fund, most TDF options are built for private sector retirement plans, which typically do not offer a pension. A pension offering, typically offered in a public-sector retirement package, dramatically skews the balance of retirement assets in a plan participant's portfolio and necessarily changes the evaluation used by a responsible plan sponsor.

Because a pension offered alongside a defined contribution plan skews the overall balance of a participant's retirement savings, there are unique criteria that plan sponsors should use to evaluate their TDF options to optimize participant outcome. Therefore, sponsors should consult retirement plan specialists to select the best TDF series for their plan.

Target Date Funds have never been more popular than they are today. Based on a study done by Vanguard, 94% of retirement plans offer a TDF option. Research showed 78% of all participants are using these funds, and these trends have steadily been growing over the past years. Today, there are over 50 different options available for plan sponsors to select for their plan.

In response to the growing popularity of TDFs, the Department of Labor (DOL) issued specific guidelines regarding TDF selection and monitoring to help plan sponsors understand their investments. A TDF is defined by its asset allocation over time, or "glidepath," and the specific investments utilized to achieve those allocations. Risk parameters help classify TDFs into risk levels based on their unique glidepath. Although many factors assist in the process of identifying risk levels of certain TDF solutions, equity exposure at retirement is the leading indicator because equity securities are responsible for a large portion of volatility in broadly diversified portfolios. TDF equity holdings can range from just 8% equity at retirement to as much as 64% at retirement, thus driving volatility at retirement. Another driving factor is the glidepath slope over time, which is the measurement of equities exchanging for bonds throughout the life of the account. The faster the exchange over time, the more conservative the fund will be.

To assist plan sponsors with glidepath identification and selection, TDFs are categorized by risk postures. Several factors are taken into consideration, including equity exposure at various points of the investment's timeline, and the rate of transition away from riskier, equity-laden investments.



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Conservative

- Objective: stability
- Lower equity exposure at retirement
- Incorporates a long and gradual transition away from risky assets

Moderate

- Objective: balance
- Moderate equity exposure at retirement
- Incorporates a more steady transition away from risky assets

Aggressive

- Objective: growth
- Higher equity exposure at retirement
- Incorporates a faster transition away from risky assets

A fit analysis should also be run. A fit analysis aims to identity the best TDF option in light of the unique plan characteristics. By utilizing plan demographics and participant behavior, plan sponsors are afforded the opportunity to choose a glidepath which is best suited to help participants reach their optimal financial destination.

Among key datapoints in selecting the correct TDF glidepath, it is important to analyze the distribution of participant savings rate and the risk associated with that glidepath. There is a correlation between savings rate and optimal glidepath for participants. The less a participant saves, the more they need to earn in the markets if they want to have enough when they retire. On the other hand, the more a participant saves, they are less dependent on the potential market gains to reach their goals and, therefore, don't need to take on as much market risk to accomplish their goals. When selecting a TDF for the entire plan, sponsors must incorporate all retirement savings, not just voluntary contributions to one plan. Therein lies the major difference for public entities compared to private corporations.

Participants who have access to a pension plan or a money purchase/401(a) plan require additional considerations relative to their private sector peers. Although each governing body has different agreements with parts of the workforce, a large majority contributes a required amount to a pension or a 401(a) plan on top of their 457 contributions. With this combination, these participants average saving at higher rates than the national average. These participants should be less dependent on market returns. Therefore, public service employees could be taking unnecessary risk by investing in an aggressive TDF glidepath.

Plan sponsors need to understand what might be best for their plan participants in order to shepherd their best outcome. This can be accomplished by measuring risk within TDF options and reviewing standard deviation with TDF options. Plan sponsors should also be aware of using proprietary options as a default rather than a true optimal option. Typically, proprietary options do not best represent the interests of each unique plan. This lack of investigation may lead to overly aggressive options, which can hurt participants unknowingly.

Taking risk off the table does not make it any less diversified of an investment portfolio. Second, there is no need for the additional risk proposed by the counterargument for the target plan participants. For example, if a plan participant is saving upwards of 12% of their salary between their pension and 457, and can meet their retirement goals with substantially less risk, why take the extra risk at all?

There are some who overlook this risk in favor of a counterargument: a relatively "conservative" TDF offered in conjunction with a pension makes the aggregate balance of the portfolio too conservative. Therefore, their TDF ought to be more aggressive to better balance the portfolio. This argument is one of diversification, but there are two problems with it. First, a portfolio including a TDF and a pension can be designed to take on less risk than a more aggressive portfolio and also be well-diversified.

The Bottom Line:

A TDF selection is more than simply putting a fund option in an account; it is representative of roughly three quarters of your colleagues' ability to have the kind of retirement for which they have saved and worked so hard. Many layperson investors simply choose the year next to the investment that most closely corresponds with their predicted retirement date – that's the point. But without a proper fit analysis, glidepath, or fiduciary advisor helping the plan sponsor choose an appropriate TDF for that plan, that TDF could be wholly unsuitable for those participants.

If a TDF fit analysis has not been completed and the glidepath not checked, it could be a bumpy road to retirement for plan participants.

AHT's methodology is designed to help every plan sponsor succeed with their own unique plan. Contact an AHT advisor to discuss your plan's fit analysis.

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