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Target Date Funds—Does One Size Really Fit All?

If you have ever opened a brokerage account with an advisor, you know the first step is gathering information to determine the risk profile and appropriate investment allocation for the individual. In order to determine the appropriate allocation for a client, financial advisors will inquire about income level, savings rate, net worth, time horizon, spending needs, investment knowledge and most importantly risk tolerance. Based on this information the advisor will recommend a tailored allocation to help individuals reach their objectives while maintaining an appropriate risk level to help ensure clients remain invested through market downturns.

However, when it comes to retirement and target date funds (TDFs), all individuals within an organization have historically been placed in the same allocation and glidepath regardless of their financial condition or risk tolerance. Plan sponsors typically select the allocation and glidepath based on the average participant at the organization. This would be like fitting shoes for a track team based on the average foot size of the team. Some team members would fall out of their shoes while others would not be able to put them on their feet.

An ill-fitting TDF brings significantly higher consequences than an uncomfortable pair of shoes. TDF misfit risk[1] can lead to participants not being prepared for retirement. If a participant is not saving enough for retirement and they are placed in a conservative TDF glidepath, they likely will not achieve an adequate income replacement ratio by retirement. Participants that have high account balances and deferral rates are exposed to unnecessary risk if placed in aggressive TDF solutions. Additionally, if a participant with a low risk tolerance is placed in an aggressive allocation, misfit risk can lead to participants pulling their money out of the market at the wrong time. In 2008, some aggressive TDFs with a 2010 target retirement date were down over 40 percent.[2] What do you think a participant two years from retirement with a low risk tolerance would do if they saw their account balance drop 40 percent? Unfortunately, many would pull their money out at exactly the wrong time and not benefit from the recovery in the markets.

Fortunately, plan sponsors no longer have to choose one glidepath for all participants in their organization. Custom solutions that include multiple glidepaths (conservative, moderate and aggressive) are now available to enable each individual participant to select a glidepath that suits their own financial situation and risk tolerance.

[1]TDF misfit risk occurs when the glidepath does not fit the participant's actual savings rate.
[2]Morningstar, Inc., Open End Funds, Category "US OE Target Date 2000-2010" containing "2010" in fund name, calendar year returns 2006-2010.

Qualified Versus Nonqualified Plans

For most employees, qualified retirement plans are a critical component of their retirement savings strategy. For others, qualified plans place restrictions on their utilization of such plans, so they have to look for other ways to save. That's why employers often offer both qualified and nonqualified plans.

Why are there two classes of plans, and how do they differ?
In the simplest of terms, qualified plans qualify for favorable tax treatment if they meet specific requirements set forth in Internal Revenue Code (IRC) 401a and ERISA. Nonqualified plans comply with IRC 409A and are exempt from most parts of ERISA. Therefore, such plans don't qualify for the same favorable tax treatment as qualified plans.

Qualified Retirement Plans
Qualified plans are broad-based employee retirement plans, meaning all employees who meet participation requirements are permitted to join the plan. The term "qualified plan" refers to two plan types: defined contribution and defined benefit. Examples of such plans are 401(k), 403(b), profit-sharing plans, pension plans, individual retirement accounts (IRAs), 457 plans and other retirement plans. The tax advantages of these plans to participants are that:

- Contributions are deducted from taxable wages in the year in which they're made
- Accumulated earnings on those contributions are tax deferred
- Account balances may be rolled over into a new employer's plan or to an IRA upon termination of employment

Employers may also deduct contributions as wages in the year in which they're made, and there are no taxable consequences to the employer on plan earnings.

Highly compensated employees are most often the senior leaders/executives in the organization. All employees who aren't determined to be highly compensated (as defined by the IRC) may enjoy the full benefits offered by their plans. For 401(k) plans, the broad base of employees may contribute up to the IRC contribution maximum ($18,000 for 2017). However, those who are defined as highly compensated are often restricted from contributing the maximum. Their deferral percentages are limited to an amount based on plan tests, such as the Average Deferral Percentage (ADP)/Average Contribution Percentage (ACP). These tests are used to ensure that all participants are benefiting equally from the plan and to determine that participants are not exceeding the IRC contribution limits.

Nonqualified Deferred Compensation Plans
Nonqualified plans are for a select group of management and/or highly compensated employees. They don't qualify for the same favorable tax treatments as qualified plans and are exempt from many IRC and ERISA requirements (including testing) because they aren't broad-based employee retirement plans. Examples of nonqualified plans are deferred compensation plans, supplemental executive retirement plans, split-dollar arrangements and other similar arrangements.

Contributions to a deferred compensation plan will reduce an employee's gross income, but there's no rollover option upon termination of employment. Contributions into a nonqualified plan aren't deductible as wages by the employer until distribution of the amounts in the participant's account. Nonqualified plans are established for a number of reasons, such as to help restore retirement parity (due to testing and contribution limits as described above). The plans also provide a means to recruit senior leadership and reward/incentivize strong performance.

Though nonqualified plans are not broad-based employee benefit plans, they still must comply with IRC 409A. This is a section of the code that provides guidance regarding the timing of deferrals and distributions. The amounts deferred into these plans aren't segregated assets as in a qualified plan; instead, they're held as general assets of the organization.

Thus, there's risk of forfeiture to the highly compensated employee in the event of bankruptcy. This is one of the main reasons a nonqualified plan is not available as a broad-based employee retirement option.

Another notable difference is the crediting of interest/earnings to a nonqualified plan. These plans are informally funded, which means that assets aren't set aside from the general assets and also aren't within the control of participants. Most organizations end up investing in mutual funds or corporate-owned life insurance (COLI) to help them offset the growing account balances. However, any interest or realized gains in a mutual fund are taxable to the organization. These plans should be designed with the financial impact to the organization in mind while balancing that with the needs of the participants.

The Bottom Line

Both qualified and nonqualified plans are key components in an employer-sponsored retirement package. While both plan types should be reviewed regularly for legal and accounting compliance, they should also both have their funding (qualified plans) and corporate financing (nonqualified plans) options reviewed. As plans grow, more investment options become available for qualified plans, and the corporate tax liability on nonqualified plans should be more actively managed. With the help of an experienced advisor, organizations can structure a retirement package that can meet the needs of all employees without being costly and inefficient at the corporate level.

Plan-Level Rate of Return—Useful or Useless?

Many people use plan-level rates of return to determine the quality of an investment lineup. However, several variables may impact plan-level rates of return making them not as useful as a plan management tool. They may actually be counterproductive when trying to determine the quality of an investment lineup. As an extreme example, you may have a lineup full of excellent mutual funds, but if your participants have 50 percent of their plan assets in a cash account, the plan's effective rate of return would suggest a poor investment lineup. Furthermore, a reasonably well-funded plan with an appropriately conservative fund menu would have an average rate of return appear sub-par during a bull market.

There are many other examples, most of which revolve around participant behavior (poor diversification, market timing, etc.) effecting a composite rate of return for the plan. We all recognize that participants consistently may not make responsible investment decisions, but imprudent participant investing should not color the quality of the investment menu.

This makes any conclusions based on average plan-level rates of return potentially misleading and probably counterproductive. A better idea is to focus on the investments that are designed to reflect the plan's goals, objectives and participant demographic needs...like a well-selected target date fund (TDF). The TDF return rates, over a reasonable time period, make more sense for comparative purposes. These options are already optimized in terms of asset allocation and divisible by age group to obtain a more risk-based conclusion. Lastly, many experts project that the vast majority (more than 80 percent) of defined contribution assets will be in TDFs by 2020[1], which makes this evaluation even more meaningful.

[1]*Center for Due Diligence.*

Returns-Based Versus Holding-Based Style Analysis

Return-based style analysis (RBSA) draws from Bill Sharpe's style analysis model, which stipulates that a manager's investment style can be determined by comparing the returns on a portfolio with those of a certain number of selected indices. Through quadratic optimization modeling, RBSA is an effective way to test whether a fund maintains its professed style mandate. RBSA examines a fund's style over a period of time and tells how the portfolio's returns behave, rather than the stocks the portfolio is actually holding (holding-based).

Holding-based style analysis (HBSA), by contrast, analyzes each of the securities that make up the portfolio. The securities are studied and ranked according to different characteristics that allow their style to be described. The results are aggregated at the portfolio level to obtain the style of the entire portfolio. Where RBSA is typically applied over a specified period, HBSA is typically conducted at a single point in time.

Reasons why we use return-based over holding-based style analysis:

- RBSA is easier to conduct: All that is needed is the portfolio's return stream and a representative set of indices for analysis.
- Period of time vs. snapshot: RBSA looks at the portfolio over a period of time. Holding-based is a snapshot of a single point in time.
- Better predictor: If the aim is to predict a fund's future returns (in a certain style), factor exposures seem to be more relevant than actual portfolio holdings. This reasoning gives advantage to RBSA.

Overall, we believe that HBSA is a more tedious and time-consuming approach. Holding-based is more of an accounting-driven approach, which stresses characteristics and categorization, rather than return behavior.

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The target date is the approximate date when investors plan on withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis with the asset allocation becoming more conservative was the fund nears target retirement date. The principal value of the funds is not guaranteed at any time including at and after the target date.

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