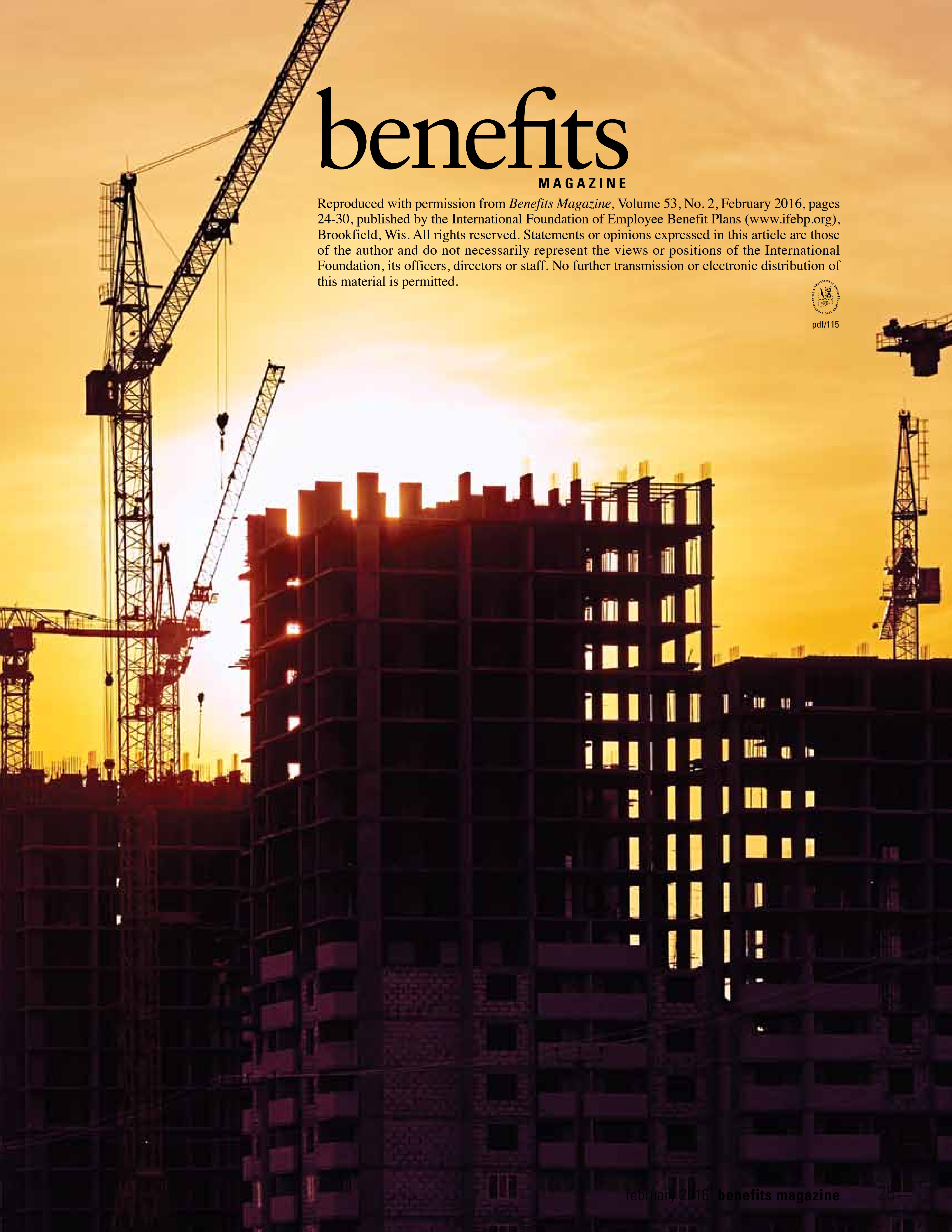
Building a Better Process for Target-Date Fund Selection

by | **Timothy R. Barron** and **Stewart D. Lawrence**

Evaluating which target-date funds to offer in a DC plan investment lineup can be equated to building a house—with a good foundation (a stable asset manager), frame (asset allocation), roof (glidepath) and walls (underlying funds).



Not so long ago, target-date funds (TDFs) were just another option among a plethora of choices in the typical defined contribution (DC) plan. However, with their frequent adoption as the default choice, as well as the push from plan sponsors to simplify the decision-making process for participants via such managed accounts, these funds have taken center stage as the "go-to" offering. This has resulted in their growth in both frequency of selection and asset values.

It is our observation that the process of evaluating and assessing these now-critical investment vehicles has lagged behind the rise in their significance as a key component of successful income replacement in retirement. At one time, there was a sense that "if I like the recordkeeper and the fund lineup provided, I'll be fine with the TDF options." Now, as an increasing amount of employees' future retirement income is riding on TDF choice, it may be time that the same—and perhaps even increased—level of science devoted to the selection of equity funds or bond funds be focused on the unique characteristics of TDFs.

This article describes a straightforward and efficient process a plan sponsor can use to rationally evaluate the quality of the TDF choices available to it.

Part One: The Foundation

In home building, there are four principal parts that must be combined to create a structure that serves as a proper dwelling: the foundation, frame, roof and walls. These basic notions can also be used to help a plan sponsor understand and assess how TDFs are built so that they serve as an appropriate and comfortable place for participants' assets to reside.

The foundation is the underpinning upon which a house sits. It must be solid and stable, able to withstand stresses over time. Given that DC plan sponsors do not want to find themselves frequently having to modify the manager lineup, it is vital that a TDF be managed by a vibrant going concern to assure the viability of the fund and the asset manager. A number of managers that entered this arena failed to raise sufficient assets and later exited the stage—quite unfortunate for any plan sponsors that selected them.

We look for four fundamental baselines as a measure of a fund's foundation:

1. It is supported by the asset manager's internal DC plan assets. This provides both a sense of commitment and alignment of interest with investors.
2. There is a live track record of effective management dating back at least five years with above-average performance. Below-average performers are likely to close due to poor results.
3. The TDF manager has a substantial DC-related business either in advisory or asset management work, indicating that the manager understands and depends on this market.
4. Assets under management are adequate to support resources required for fund management.

Rate each of the four fundamentals numerically, from strongly agree (5) to strongly disagree (1), and calculate the average score. Note that a level of assets being managed is not specified, and there may be an upper and a lower limit for effectiveness. The level of invested assets is an indicator of sustainability and commitment but is not the only measurement or criterion.

Part Two: The Frame

The frame shapes the structure, providing its basic form or outline. In our assessment of TDFs, this relates to the asset allocation methodology and asset classes. These characteristics are the key drivers of long-term investment return, as has been demonstrated time and again by academics and practitioners alike, giving any TDF its most important structural component.

The characteristics of the asset classes and how they are combined form the basis for all other aspects of TDF management. If the classes do not combine optimally to create a diversified portfolio, then no amount of manager-generated excess return or tinkering with the *glidepath* (the method of resetting the asset allocation as time progresses toward the target date) can offset the weighty impact of those decisions. It is also our observation that plan sponsors have been so distracted by the other features of TDF construction that they have lost sight of the fact that without a well-crafted framework, the fund is unlikely to achieve its goals.

There are seven key features to an effective approach to asset allocation:

1. It considers a wide variety of asset classes (not solely ones where the asset manager has available product), enabling sound diversification and risk control.
2. Expected returns and other assumptions used in developing the portfolio are forward-looking and grounded in sound capital market theory (as opposed to simple

historical data with little empirical relationships among class returns).

3. It allows for flexibility in adding asset exposures as new opportunities become available due to product developments, such as liquid alternatives. (*Liquid alternatives* aim to provide similar diversification and return characteristics as hedge fund and private market investments, but with greater liquidity and lower minimum investment requirements. They are offered in the form of mutual funds and subject to the regulations of the Investment Company Act of 1940.)
4. Rebalancing ranges are both clear and consistently applied over time with an eye toward both policy adherence to lower *tracking error* (the level of divergence between the return on the portfolio and the return of the benchmark) and cost.
5. Minimum and maximum allocations to asset class exposures are reasonable and aligned with both sound fiduciary principles and potential loss risk relative to time horizon.
6. The number of end-date options is sufficient for participants to select a TDF or combine TDFs to approximate their targeted date of retirement or fund payout.
7. Conflict of interest is minimized with an asset allocation structure that has little or no impact on the revenue received by the manager of the TDF or any associated entity.

Again, rate each of the seven key features numerically, from strongly agree (5) to strongly disagree (1), and calculate the average score.

TABLE I

Sample Glidepaths

Glidepaths represent the mechanism or process for modifying a TDF's asset allocation as time passes. Each glidepath includes parameters for how and when changes should be made.

Glidepath	Parameters
To	The retirement target date is the point at which more stable returns and income become most important (derisking).
Through	Acknowledges longevity risk by derisking at some point after the target date
Declining Path	Decreases the equity position over time after beginning with larger equity or risk exposure
Dynamic	Dynamically adjusts the asset allocation based on the fund manager's capital market expectations
Liability-Driven	Adjusts asset allocation to maximize wealth by tracking the retiree's account balance

Source: Segal Rogerscasey.

Part Three: The Roof

The roof plays the critical role of keeping occupants protected from the elements. For TDFs, this is the glidepath: By shifting to a more stable asset allocation as a participant ages, the risk of principal loss is reduced. On the flip side, an otherwise good, solid target-date provider with an appropriately developed asset allocation can be significantly damaged by a TDF with a glidepath that is poorly developed or designed.

Unfortunately, for those evaluating TDF effectiveness and potentially for individual investors, this element truly has become the most complicated of all, as there are a host of alternative mechanisms, many with little or no support and some with only academic literature for support. As always, the notion of innovation to improve outcomes often is barely distinguishable from designs that are attractive only for purposes of hyperbole and sales. This article is not intended to be an exhaustive assessment of those options, but rather it is meant to assist in the evaluation process from a "best manager" and "best fit" perspective. The degree of complexity is well-illustrated by the number of approaches available (see Table I).

The keys to rating this important element of the TDF manager can be summarized by four guidelines:

1. The glidepath makes intuitive sense relative to the plan sponsor's approach to providing employee benefits in general. This is complex but, in short, some methods are likely to provide greater protection by ramping down equity commitments more rapidly. Some will be more appropriate for retiree patterns of removing assets from the TDF at retirement, and some will provide an expectation that actively managing the asset allocation through time (buying low and selling high) can be effective. No path will be perfect, and all are rife with assumptions that the capital markets may not reward as expected.
2. The asset manager understands the first guideline and makes no pretense about the biases and imperfections of its adopted method. In short, it knows why it has adopted this approach and can effectively communicate its rationale.
3. The glidepath was designed with strong quantitative and qualitative rigor. The manager is able to provide statistical analysis to demonstrate the range of outcomes for the selected glidepath along different time horizons and market environments.
4. The manager's approach to the glidepath has been stable, and any changes have evolved and been implemented with reason and care.

As with other categories, we suggest a scale from highly favorable (strongly agree, rated as a 5) down to highly unfavorable (strongly disagree, rated as a 1).

Part Four: The Walls

The walls define areas, carry loads and provide shelter. In our building analogy, this represents assessing the underlying funds as the final step in implementation of the TDF review process. These are the portfolios of stocks and bonds or other investments that are managed actively or passively in order to try to improve either the returns generated or the level of volatility experienced, or simply to efficiently replicate the desired exposure. This is the part of the evaluation process that plan sponsors are most familiar with because it has the most straightforward benchmarks for comparison, which also makes it the fun part.

Let us break down some of the key options in the evaluation process. First, there are two major directional options: passive vs. active management and closed vs. open architecture. *Passive* (benchmark replication) provides a low-cost and simple way to assess asset classes and is a very valid choice. We suggest a simple look at fees and tracking error as a way to judge the passive options. Any scoring system will have little influence over the end result, as it is principally a very modest differentiator once the decision has been made to select passive options—so manager selection is viewed as neutral.

In terms of active management, choices will be either *closed architecture* (proprietary) or *open architecture* (nonproprietary) or some combination thereof. *Closed* means the managing entity uses only products where it serves as the portfolio manager for the underlying funds. *Open* means the managing entity uses products managed by other firms in every category, and the combination simply means a little of both. There is also the possibility of having a mix of passive and active management with a combination of proprietary and nonproprietary products.

We believe it is prudent to assess every underlying fund, regardless of the managing entity, and to develop a broad-

takeaways

- Plan sponsors should ascertain that a TDF is managed by a going concern, helping assure the fund and the asset manager will remain viable.
- Which asset classes are used and how they are combined are the basis for all other aspects of TDF management.
- An effective approach to asset allocation is to consider a wide variety of asset classes, allow for flexibility as new investment products are developed, have clear rebalancing ranges and have a number of end-date options.
- Evaluating a fund's glidepath is complicated, and no glidepath is perfect. The manager should be able to provide statistical analysis to demonstrate the range of outcomes along different time horizons and market conditions.
- Straightforward benchmarks are available to help plan sponsors evaluate the underlying funds in a TDF.
- Effective TDF providers convey a consistent thought process or investment message.

based score for all funds offered. This does, however, create a great deal of complexity, as the typical TDF may have 15 to 20 underlying investment options. Nonetheless, we believe a fiduciary has a responsibility to evaluate underlying funds regardless of the level of effort required.

The optimal solution is to combine quantitative and qualitative processes to provide a complete yet manageable response to this important task:

- **Quantitative process**: Step one is to create a straightforward quantitative framework that is based on characteristics that can provide some insight into manager skill. It is important that this go beyond just historical performance, but it should incorporate that aspect as well. Factors to be assessed include various measures of historical performance, volatility and consistency.
- **Qualitative process**: We also believe that, whenever possible, additional due diligence must be applied to increase the predictive potential of the assessment of forward-looking manager skill. This qualitative process involves interactive understanding of what drives manager success with a framework for assessing and comparing various factors such as organizational stability, team skill and competitive advantage, the investment value proposition or thesis, the investment process and operations or risk management.

In order to integrate the quantitative and qualitative aspects of manager or product evaluation, the plan sponsor or advisor can combine the analysis in a systematic way to generate a composite score for each portfolio within the TDF. This is shown in Table II using a numeric scoring system.

It is possible to fail (score zero) on a qualitative factor. In that event, we believe the total score should drop to zero because any completely unacceptable characteristic simply should not be tolerated. It is then possible to score each underlying product with the TDF and weight those according to the asset allocation of a particular fund target year (2030, for example) to derive a composite score for the underlying portfolio of funds. To create consistency with the other categories discussed above, bracket the total score so that 21 to 25 gives five points, 16 to 20 equals four points and so on.

TABLE II

Sample Composite Score for Portfolio 1*

Quantitative		Qualitative	
Factor	**Score**	**Factor**	**Score**
Rolling 3-Year Returns	3	Stability	5
Volatility	5	Team	2
Tracking Error	1	Philosophy	4
Cumulative Returns vs. Index	4	Process	4
Sharpe Ratio	3	Operations	3
Weight: 40%	**Total Score: 16**	**Weight: 60%**	**Total Score: 18**
	Grand Total: 17.2 out of 25		

*For illustrative purposes only.

Source: Segal Rogerscasey.

TABLE III

Sample Final TDF Evaluation and Comparison

	Firm 1	Firm 2	Firm 3
The Firm (Foundation)	5	3	4
Asset Allocation (Frame)	4	3	2
Glidepath (Roof)	4	5	1
Underlying Funds (Walls)	3	4	4
Consistency (Builder)	+ (positive)	o (neutral)	– (negative)
Total Score	**16+**	**15 o**	**11–**

Source: Segal Rogerscasey.

Putting It All Together: The Builder

The builder is responsible for making certain that all elements of the project come together in an effective way. We believe that effective and successful TDF providers are able to convey consistency of thought process or "investment message" across all components of an offering. Preferred providers are able to balance and, more importantly, anticipate market demand and investment theory, adding new ideas that have sound invest-

bios

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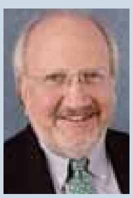

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ment logic, while doing so in a way that is seamless to the plan sponsor and participant. Although it is possible to develop a quantitative score for the builder, we suggest that it simply be a positive, a neutral or a negative rating that could tilt a final score one way or the other in the event of a cluster of similar scores.

The Final Evaluation

In the final step of the evaluation, we combine the composite score of the four components of each firm's TDF offering and compare them, as shown in Table III.

This scoring system allows flexibility to weight the four components variably based on the preferences of the plan sponsor. We believe that equal weighting, as shown in Table III, will be a reasonable method in many situations. It is also possible to establish certain minimum criteria such that, for example, any firm scoring a 1 or below on any component is automatically eliminated from consideration.

We have not described the role of fees and costs in the evaluation, and this certainly is a factor in the decision-making process. We suggest that the evaluation described above be completed without consideration of fees to develop a short list of candidates that can then be compared in terms of that feature. Depending on the confidence level in future performance prospects, a higher fee product may still be preferable. Of course, this should be a topic of great scrutiny. In addition, armed with a thorough analysis, a plan sponsor may also be in a position to negotiate a better fee from the highest scoring provider.

Conclusion

While there are numerous methods that can be applied to assess TDFs, we believe that the process outlined above can be effective in assessing providers for this important part of a DC plan's investments. It is a 360-degree approach encompassing all elements of plan design. It is flexible, allowing the plan sponsor to adapt to specific, custom circumstances. It combines the quantitative and qualitative elements of the TDF and can be implemented in a repeatable, consistent manner. With TDFs becoming the largest part of the asset pool for many DC plans, it is crucial that the fiduciary have a documented process for delivering a well-constructed option to participants.