Improving the Target Date Fund Selection

by Chris Karam
The target date selection process has dramatically changed over the last five years aided by government regulations, an increase in the number of target date suites and the availability of new products and glide paths. Many plan sponsors, working with record keepers offering a proprietary target date suite, may have had only a handful (sometimes just one) option available during the initial selection process. According to Morningstar's 2013 Target Date Series Research Paper, over 92% of the open-ended mutual fund target date assets reside at just 10 money management firms. Of those 10 money managers, 8 offer recordkeeping services. This white paper offers a road map to help plan sponsors determine whether the current target solution is the appropriate choice.

The stock market downturn from October, 2007 through March, 2009, put target date funds under a microscope and caught the eye of the Securities and Exchange Commission and the Department of Labor (“DOL”). The increased scrutiny culminated in DOL “tips” for plan sponsors to evaluate the appropriateness of their target date funds.

This white paper is a guide for plan sponsors to establish the necessary framework to successfully select a target date suite for their participants. Target date funds are not created equal and plan sponsors should approach the manager selection process with open eyes. With the strong process in place that we outline in the following pages, plan sponsors can best determine which TDF glide paths meet their goals and objectives.
Developing a Plan Sponsor Road Map for Fiduciary Success

Target date funds are now used in over 68% of retirement plans today, according to a 2012 Profit Sharing Council of America survey. Asset flows into target date funds continue to build momentum. Total assets in open-ended mutual fund TDFs increased by 21% to $518 billion in the first quarter of 2013 and inflows during the first quarter 2013 were $23 billion, according to Ibbotson’s Associates.

The rapid ascendance of TDFs is tied to a number of factors, most especially the increased desire of participants for asset allocation assistance based on their age. Additionally, numerous behavioral finance studies reinforce the movement towards auto contribution features, higher default deferral rates and higher caps on annual deferral escalators. We believe that, above all, the fiduciary safe harbors offered to plan sponsors for incorporating the aforementioned auto features, coupled with the government legislation codified in the Pension Protection Act of 200 which permit the use of asset allocation funds to function as an acceptable qualified default investment alternative (“QDIA”), have quickly driven billions of dollars of assets towards target date options.

The growth of the target date fund industry has translated into escalating allocations within defined contribution portfolio line-ups. At the same time Plan Sponsors face increased fiduciary responsibility for monitoring the performance and appropriateness of these funds. With target date funds still relatively novel products, and few industry measurement tools with which to evaluate them, plan sponsors are potentially exposed to fiduciary gaps surrounding the process of target date fund selection, performance monitoring, and the corresponding required documentation.
Historically plan sponsors have relied on their investment policy statements to reference the appropriate collection of peer groups and benchmarks to adequately select and monitor a particular manager’s performance. Many investment policy statements, however, lack clear language dedicated to selecting and monitoring target date funds. This fiduciary gap exists at a time when target date funds are on pace to claim the largest share of defined contribution plan asset allocations. Today, target date funds capture nearly 65% of inflows into defined contribution plans.

Whether because of the lack of open architecture, or just a limited number of product options, plan sponsors may have been hamstrung when they initially selected their target date fund suite. Many plan sponsors were likely offered as few as one target date alternative. Fidelity rolled out their open-ended mutual fund target date fund suite in 1996. Large target date providers such as Principal (2001), T. Rowe Price (2002) and Vanguard (2003) followed suit and gathered significant market share by encouraging their recordkeeping clients to add their proprietary target date suite.

The Department of Labor has taken notice and recently issued eight tips to help plan fiduciaries with target date fund selection. Plan sponsors can use this guidance to determine the most prudent actions in the context of their specific plan goals and participant needs. The eight tips are listed below.

Pensions & Investments, Callan: Target-Date-Funds to Capture Lion’s Share of DC Plan Allocations, March 12,
Department of Labor Eight Tips:

1. Establish a process for comparing and selecting TDF’s
2. Establish a process for the periodic review of selected TDFs
3. Understand the fund’s investments
4. Review the fund’s fees and investment expenses
5. Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan
6. Develop effective employee communications
7. Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection
8. Document the process
Developing a Plan Sponsor Road Map for Fiduciary Success

This Target Date Fund Fiduciary Road Map will supply Plan Sponsors with a strategy to successfully implement a manager selection process that accommodates the current target date fund landscape and mindful of the DOL tips. The Road Map will consist of five white papers designed to outline the practical steps that Plan Sponsors can follow to help them identify the Target Date Funds that best meet the their overall plan objectives and serve the needs of their participants. The five step process is outlined below.

Our first paper is focused on conducting a strategic plan review and its impact on the target date fund selection. Key areas of focus of the strategic plan review include evaluating the following.

- Plan Design
- Participant Demographics
- Glide Path Preferences
- Portfolio Construction
- Expenses

Below is the questionnaire to identify the plan sponsor’s goals and objectives, assess participant behavior unique to their employees, define risk tolerance and time horizon, determine the role of diversification, asset class and manager selection, and develop an expense policy.
## Plan Design

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<thead>
<tr>
<th>Section</th>
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<tbody>
<tr>
<td>Plan Design</td>
<td>How important is it to keep participants in the plan after age 65.</td>
<td>1. Not a priority.  2. Somewhat important.  3. Very important.  4. Of utmost importance.  5. Don’t know.</td>
<td>Multiple Choice</td>
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<tr>
<td>Plan Design</td>
<td>How important is it for the plan to serve retirement income needs?</td>
<td>1. Not a priority.  2. Somewhat important.  3. Very important.  4. Of utmost importance.  5. Don’t know.</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Plan Design</td>
<td>From highest to lowest, with highest being most important, rank the following attributes for your plan:</td>
<td>1. Retaining plan participants.  2. Increasing plan enrollment.  3. Offering a wide selection of options.  4. Offering an income component in the plan.  5. Making sure that the fund choices are cost effective for participants.</td>
<td>Rank</td>
</tr>
<tr>
<td>Plan Design</td>
<td>From highest to lowest, with highest being most important, rank the following attributes for your Target Date Funds:</td>
<td>1. Making sure the fund offers significant downside protection for near term retirees.  2. Making sure the glide path of equity exposure is gradual.  3. Making sure the fund offers a high degree of success for retirees through retirement.</td>
<td>Rank</td>
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## Participant Demographics

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| Participant demographics | In your opinion, how do participants behave in periods of market volatility? | 1. Exhibit very reactive behaviors.  
2. Exhibit somewhat reactive to market conditions.  
3. No more reactive than average.  
4. Less reactive than average.  
5. Don’t know.                  | Multiple Choice               |
| Participant demographics | How important is the role of Target Date Fund (TDF) education and communication in executing a target date strategy? | 1. Not important.  
2. Somewhat important.  
3. Very important.  
4. Of utmost importance.  
5. Don’t know.                  | Multiple Choice               |
| Participant demographics | What are your expectations for the growth of union membership?           | 1. Union membership is likely to decline.  
2. Union membership will hold steady.  
3. Union membership will grow slowly, less than historically.  
4. Union membership will grow quickly, more than historically.  
5. Don’t know.                  | Multiple Choice               |
| Participant demographics | How much of the retirement for the majority of participants will be funded via their savings in the company plan? | 1. All  
2. Most  
3. More than half.  
4. Less than half.  
5. Very little.  
6. Hardly any.  
7. Don’t know.                  | Multiple Choice               |
| Participant demographics | What are your expectations about future employer cash flows into the plan? | 1. Unlikely to change.  
2. Likely to decrease.  
3. Likely to remain the same.  
4. Likely to increase.  
5. Don’t know.                  | Multiple Choice               |
## Glide Path

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<tr>
<td>Glide Path</td>
<td>Do your participants require a unique or customized glide path?</td>
<td>Yes/No/Not Sure</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Glide Path</td>
<td>If you answered “yes” above, why (what are the reasons you think they might require this)?</td>
<td></td>
<td>Open Ended</td>
</tr>
<tr>
<td>Glide Path</td>
<td>If you answered “yes” above, what might be some characteristics of a “unique” glide path that you think would be important?</td>
<td></td>
<td>Open Ended</td>
</tr>
<tr>
<td>Glide Path</td>
<td>What has been your experience with Target Date Funds (TDF)?</td>
<td>1. Very favorable. 2. Somewhat favorable. 3. Neutral. 4. Unfavorable. 5. N/A.</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Glide Path</td>
<td>How would you characterize your thoughts around equity exposure in TDFs?</td>
<td>1. There should be a high level of equities throughout the life of the fund. 2. Equity allocation should be much lower at retirement. 3. Equity allocation should be much lower 20-30 years after retirement. 4. Don’t know.</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Glide Path</td>
<td>Where do you think an equity allocation should be for a participant 20 years away from retirement?</td>
<td>Equity Allocation Scale 1. 10% 2. 20% 3. 30% 4. 40% 5. 50% 6. 60% 7. 70% 8. 80% 9. 90%</td>
<td>Multiple Choice</td>
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<td>Portfolio Construction</td>
<td>Are you comfortable with the use of derivatives in a TDF?</td>
<td>Yes/No/Not sure.</td>
<td>Multiple Choice</td>
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<tr>
<td>Portfolio Construction</td>
<td>Based on what you know, do you prefer “active” or “passive” investments in the plan?</td>
<td>1. Active. 2. A mix of both, with a preference for active. 3. A mix of both, with a preference for passive. 4. An equal mix. 5. Passive. 6. Not sure</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Portfolio Construction</td>
<td>What is your ideal mix of domestic/international holdings—across all asset classes?</td>
<td>Domestic/International 1. 90%/10% 2. 80%/20% 3. 70%/30% 4. 60%/40% 5. 50%/50% 6. 40%/60% 7. 30%/70% 8. 20%/80% 9. 10%/90%</td>
<td>Multiple Choice</td>
</tr>
<tr>
<td>Portfolio Construction</td>
<td>Do you prefer a portfolio with individual securities or a fund-of-funds?</td>
<td>1. Fund-of-funds. 2. A mix of both, with a preference for fund-of-funds. 3. A mix of both, with a preference for individual securities. 4. An equal mix. 5. Individual securities. 6. Not sure</td>
<td>Multiple Choice</td>
</tr>
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</table>
# Portfolio Construction

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| Portfolio Construction | Do you prefer a portfolio with individual securities or a fund-of-funds? | 1. Fund-of-funds.  
2. A mix of both, with a preference for fund-of-funds.  
3. A mix of both, with a preference for individual securities.  
4. An equal mix.  
5. Individual securities.  
6. Not sure | Multiple Choice       |
| Portfolio Construction | Do you prefer a single manager or multi manager approach?               | 1. Single manager.  
2. A mix of both, with a preference for a single manager.  
3. A mix of both, with a preference for multi-manager.  
4. An equal mix.  
5. Multi-manager  
6. Not sure | Multiple Choice       |
| Portfolio Construction | Are there any particular investment vehicles to which you are opposed (commingled pool, separate account, etc...)? |  | Open Ended       |
### Expenses

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</table>
| Expenses| How important is it for the TDFs to have similar expenses?               | 1. Not a priority.  
2. Somewhat important.  
3. Very important.  
4. Of utmost importance.  
5. Don't know. | Multiple Choice |
| Expenses| TDFs should have expense ratios in what range?                           | 1. 10-30bps OR 0.10%-0.30%  
2. 30-50bps OR 0.30%-0.50%  
3. 50-70bps OR 0.50%-0.70%  
4. 70-90bps OR 0.70%-0.90%  
5. 90-110bps OR 0.90%-1.10%  
6. 110-130bps OR 1.10%-1.30% | Multiple Choice |
| Expenses| In order of preference, rank the following as means of keeping expenses reasonable: | 1. Zero revenue investment options.  
2. Use of revenue-generating funds.  
3. Use of levelized “wrap fee” for recordkeeping. | Rank |

The strategic plan review is step one of the five step process and lays the foundation for selecting an appropriate glide path. Our next white paper will focus on the glide path selection process using the metrics established in the strategic plan review. Glide paths are not all created equal and a proper target date fund selection process will allow plan sponsors to conduct a fair performance analysis amongst suitable product offerings. The underpinning of a sound process begins with establishing goals and objectives during the strategic plan review. The remaining steps towards selecting an appropriate target date series are organized around successfully completing the strategic plan review.
About Sheridan Road Advisors

Sheridan Road Advisors, LLC (“Sheridan Road”, the “Company”, or the “Firm”) is an independent, objective, and holistic institutional investment consulting firm that provides Retirement Plan Consulting Services, Executive Benefits and Wealth Management Services. We oversee approximately $10 billion in assets and serve more than 260,000 participants in our retirement plans. Sheridan Road focuses on both corporate and tax-exempt defined contribution and defined benefit retirement plan consulting with approximately 80% of the total assets under management coming from these services.

Sheridan Road currently works with approximately 230 retirement plan clients across more than 20 states representing virtually every market segment and industry group. Our clients’ retirement plans range in size from the middle-market (< $50 million) to the institutional plan market (> $1 billion). The Company has offices in Chicago, Indianapolis, Milwaukee, Minneapolis, Nashville, New York, and Tampa to better service our client base.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment advice offered through Independent Financial Partners (IFP), a registered investment advisor. IPF, Sheridan Road Advisors and Sheridan Road Financial are separate entities from LPL Financial.

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The principal value of a target fund is not guaranteed at any time, including at the target date.

The target date is the approximate date when investors plan to start withdrawing their money.

No strategy assures success or protects against loss.

Investing involves risks, including possible loss of principal.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Fund of hedge funds involve special considerations and risks not associated with an investment in traditional mutual funds. Each fund’s investment program is speculative and includes risks inherent with an investment in securities, as well as specific risks associated with the use of leverage, short sales, options, futures, derivative instruments, investments in “junk bonds”, non-US securities, illiquid investments and limited regulatory oversight. Each fund is a non-diversified fund and invests in Hedge Funds that may invest a substantial portion of the assets managed in an industry sector. Higher fees, potential investor income qualifications and strategy limitations must be considered in any suitability determination.

Investing in private equity is subject to significant risks and may not be suitable for all investors.

The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Derivatives are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing the entire amount paid for the option.

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Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus and, if available, the summary prospectus contain this and other important information about the investment company. You can obtain a prospectus and summary prospectus from your financial representative. Read carefully before investing.