Rocaton

INSIGHTS

Custom Target Date Options: A Higher Hurdle

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Given the high utilization of target date options in defined contribution plans, target date options are receiving ever greater scrutiny. It is now a common practice to utilize target date options as the plan's designated default and plan design changes such as the use of auto enrollment and re-enrollment are driving more assets to these options. Asset managers are eager to participate in the growth of these strategies and are focused on either offering a target date solution and/or being part of a custom target date solution. As such, custom target date options are becoming a more popular discussion topic. While there are many factors that could lead a plan sponsor to seriously consider custom target date options, Rocaton believes there are a few key considerations that should receive the most weight when considering custom target date solutions. We suggest that there should be a higher hurdle for custom implementation and we outline a number of considerations for custom target date options in the following paper.

EXECUTIVE SUMMARY

* Target date funds continue to gain in popularity, primarily in off-the-shelf strategies, and are on track to become an even greater portion of many defined contribution plans in the years to come.
* Plan demographics are commonly cited as the most important reason for considering a custom target date strategy. While some argue that plans with differing demographics may benefit from a custom glidepath, Rocaton believes that only in the most unique circumstances would demographics alone warrant a custom glidepath, and there is a sufficient array of commercially available glidepaths to fit the demographic needs of most plan populations.
* However, there may be broader applicability for the use of custom target date options for plan sponsors that wish to utilize their own core investment lineup, that have a specific view on active management, or that value a larger allocation to non-traditional asset classes.
* For plan sponsors that wish to utilize their core lineup, Rocaton believes leveraging the due diligence used in manager selection and potential investment management fee economies of scale are potentially more compelling arguments for a custom approach.
* A custom implementation accommodates plan sponsor preferences, such as a specific view on active management, which appear to vary meaningfully across the industry. While some products offer a hybrid of active and passive underlying options, sponsors have no say in that mix in an off-the-shelf solution.
* More recent developments that could lead plan sponsors to revisit custom target date include increasing interest and product development in alternative strategies for DC plans, and the DOL's focus on custom target date as part of its *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries.* Less liquid alternatives in DC plans, while still fairly rare, may gain traction in target date funds, particularly (but not exclusively) in custom options.
* Finally, fees for custom solutions may provide cost savings relative to off-the-shelf solutions. This argument may be less compelling for plan sponsors that currently utilize a fully passive target date solution, and the case could vary meaningfully depending on the circumstances of each plan and the specific providers utilized.

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Introduction

Not surprisingly, the number of target date strategies offered by investment managers has grown meaningfully in recent years. As a result, many plan sponsors have been able to find an appropriate off-the-shelf product. However, there are a number of reasons why plan sponsors might want to consider a custom target date fund offering. Importantly, what is customized in a custom target date offering can vary and may include glidepath design, manager selection and/or asset class selection. The balance of this paper provides an overview of the custom target date landscape and details considerations plan sponsors should keep in mind when determining whether to offer a custom target date product.

Why consider custom target date funds now?

Although custom target date funds have been around for many years, the great majority of plan sponsors have relied on commercially available products. However, given the increasingly important role that target date funds have in many defined contribution plans, this may be an appropriate time for some sponsors to review the custom target date fund landscape.

To begin, assets in target date funds continue to grow, reaching approximately $850 billion at the end of 2013[1]. As shown in Figure 1 on the next page, target date funds continue to grow in popularity as more plans are offering target date funds, often as the default option, and more participants are holding target date funds. As a result of the continued popularity, the cost of moving to a custom target date offering has come down meaningfully (see additional information below) and the technology used to implement these custom solutions has improved materially. Research by Rocaton suggests costs have in fact come down and that smaller plans may be able to create a cost competitive custom solution.

Aside from growing assets and lower costs, there has been increasing interest in including alternative asset classes in defined contribution plans (hedge funds and risk parity strategies, private real estate, private equity, etc.). The most natural home for these asset classes and strategies in a DC plan may be inside a custom target date fund.

Finally, in 2013, the Department of Labor's Employee Benefits Security Administration (DOL EBSA) published *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries,* which focused on target date fund basics and items plan sponsors should consider when evaluating these funds. In this publication, the DOL suggested that plan sponsors inquire about whether a custom or non-proprietary target date fund would be a better fit for their plan. Interestingly, this suggestion was made without regard to plan size.

1 Vanguard's "Perspectives on custom target-date strategies in DC plans". March 2014.

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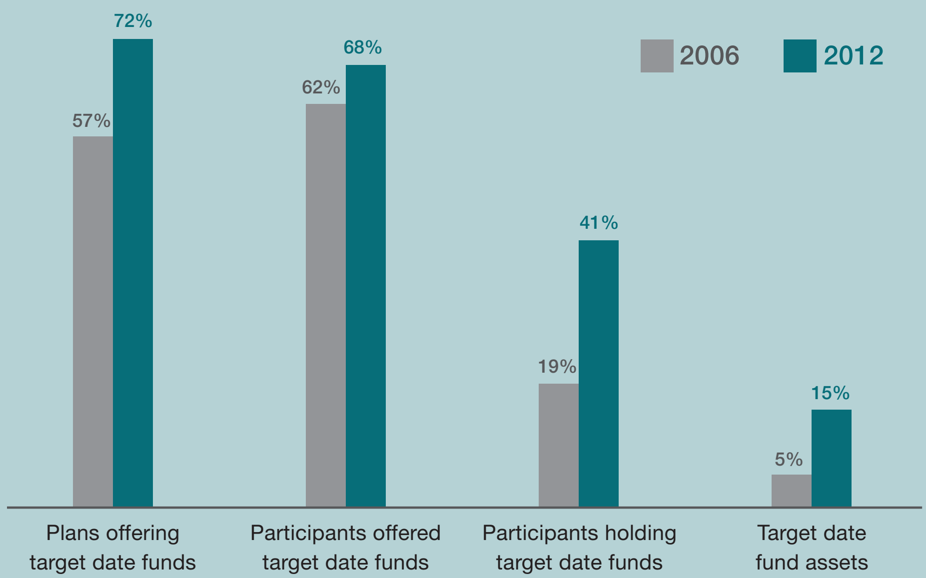
Figure 1:
Target Date Funds' 401(k) Market Share



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Do demographics really matter?

One of the most commonly cited reasons for building a custom target date fund is plan demographics. The rationale is fairly intuitive as plans that offer a defined benefit (DB) plan, those with a very young or older workforce, and/or those with a retirement age that is very different than the typical retirement age, for instance, may benefit from a non-commercially available, tailored glidepath. However, given the range of commercially available glidepaths (as demonstrated in the illustrative representation of glidepaths in Figure 2), it is difficult to argue that many plans have demographics that are unique enough to warrant a glidepath that looks meaningfully different than one that is commercially available. In fact, given a particular demographic characteristic, offsetting arguments can be made about how that characteristic should impact the glidepath design. For example, the presence of an open defined benefit plan may cause plan sponsors to reach two different conclusions. One side of the argument suggests that employees with a defined benefit plan can take more risk given the "safety net" of the DB plan benefit. Conversely, it also could be argued that the existence of a DB plan would lead participants to take less risk since the DB plan benefit will help them reach their retirement savings goals more easily. The story gets more complicated when only a portion of the workforce has a significant DB plan benefit such as in the case, for example, of a closed DB Plan. Therefore, we believe most plan sponsors should also identify strongly with one or more of the following possible rationales for custom target date before selecting a custom target date solution.

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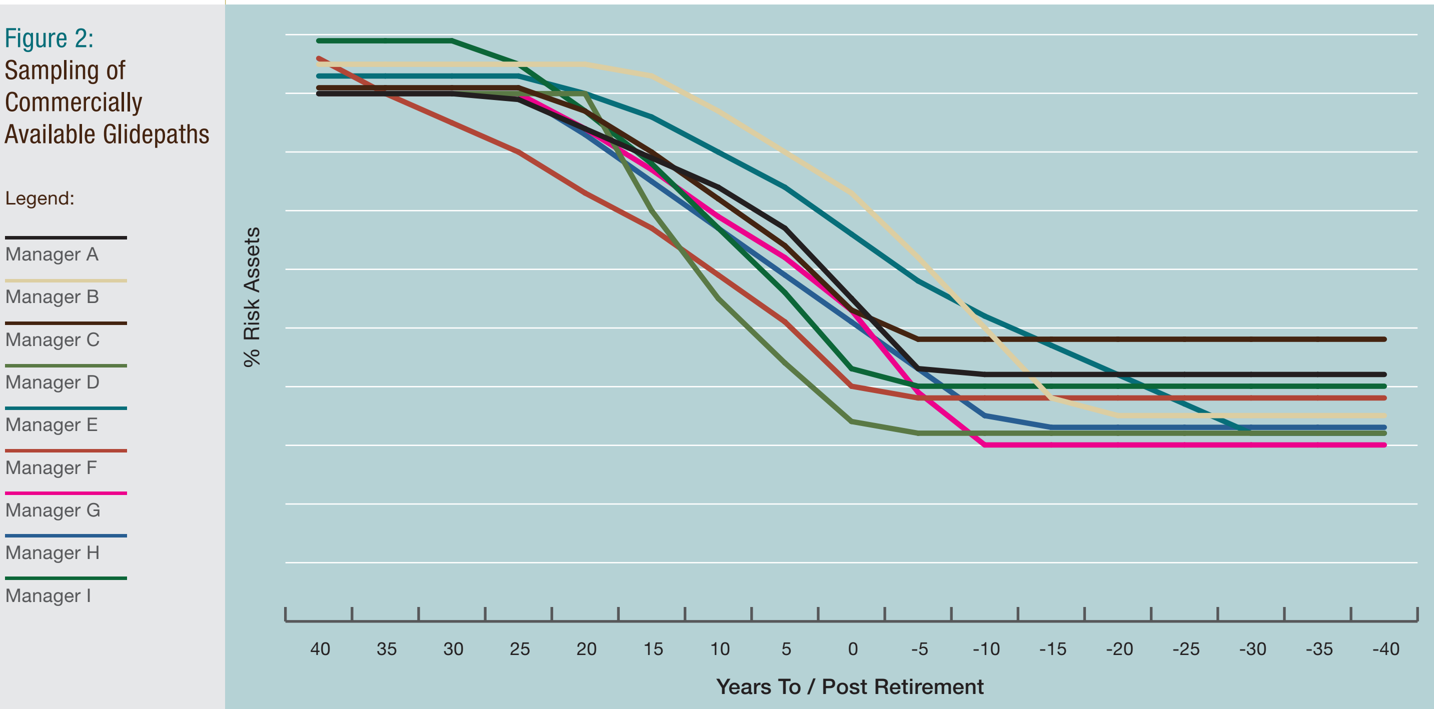
Figure 2:
Sampling of Commercially Available Glidepaths



Note: Illustrative glidepaths not meant to represent any one provider in the marketplace.

Other Possible Rationales for Building a Custom Target Date Option:

Plan sponsor wants to utilize the core lineup

While Rocaton believes that some active asset managers have skill across an array of asset classes and strategies, it is unusual for a single active management firm to excel in every asset class. Even entirely passive strategies and strategies from firms that use multiple unaffiliated subadvisors may have limitations. Custom funds give plans the potential to select managers in an open architecture framework and offer more control over the underlying manager allocations, leveraging the due diligence and ongoing monitoring that goes into manager selection for the plan's core menu. The core menu can also be supplemented with additional asset classes (i.e. certain strategies may be appealing within a custom target date fund, but not necessarily as a standalone core option).

Plan sponsor has a specific view on active management

For plans that value active management and the strategic use of active managers, a custom solution may be appealing. Although many asset managers have created multiple versions of their products that include varying degrees of active management, these products may have some shortcomings. Based on Rocaton's analysis of the top ten providers by assets (combining mutual fund and collective trust data), we identify seven providers that offer a fully active solution, six that offer a fully passive solution and four that offer hybrid solutions, which consist of a mix of active and passive management. A plan sponsor may wish to index exposure in asset classes where active management is less compelling (e.g. large cap U.S. equity) and utilize active management in less efficient asset classes (e.g. high yield). In

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off-the-shelf solutions that utilize a hybrid approach, that blend of active and passive management has been determined by the investment manager and may not align with a plan sponsor's views. A custom implementation may allow a plan sponsor to choose the asset classes where active management makes the most sense. Further, the ability to use active management in some places and not in others can also help control overall costs.

Plan values a larger allocation to non-traditional asset classes

Historically, off-the-shelf target date funds have not included meaningful allocations to non-traditional asset classes (generally less liquid and illiquid asset classes and strategies) due to a lack of perceived sponsor and participant receptivity. Rocaton believes non-traditional asset classes will play a larger role over time and such allocations have started to increase in many target date funds. However, if a plan sponsor currently seeks a larger allocation to non-traditional asset classes, it may be better served with a custom application.

Plan sponsors that currently have a fully passively-implemented target date option should be aware that, industry-wide, target date fund allocations may be growing to asset classes and strategies where it is either more difficult to implement passively or where the case for passive may be less clear than in certain "core" asset classes, such as U.S. equity, for example. In recent years, a number of major target date funds have increased the combined allocation to asset classes such as smaller cap equities, non-US and emerging markets, non-US fixed income, high yield and commodities. To the extent those categories comprise even greater allocations in coming years, this may warrant further consideration of a growing number of off-the-shelf hybrid active/passive target date options or potentially custom approaches, where the plan sponsor can more directly influence the specific active/passive decision.

Compelling fees relative to comparable products

Certainly all plan sponsors would like to offer the lowest possible fees for participants. For plan sponsors interested in an entirely or predominantly passive approach to target date funds, there may be fewer reasons to implement a custom solution as the fees for off-the-shelf passively managed strategies can be quite compelling, are often negotiable, and are difficult to replicate in a custom framework. Absent an entirely passive approach, a custom solution can potentially lower fees, although plans generally need the necessary size/scale to achieve these relative fee savings and fees could vary meaningfully depending on the circumstances of each plan and the specific providers utilized. It should, however, be noted that asset thresholds to achieve fee savings have been decreasing over time. Historically, an unofficial industry rule of thumb was that plans needed at least $1 billion in target date assets to consider a custom approach.

A recent survey conducted by Rocaton of retirement industry professionals working at asset managers, firms with recordkeeping services and investment consulting firms (with data summarized in Figure 4 below) suggests that the hurdle for building a custom target date fund today falls somewhere between $250 and $500 million in total plan size. Looking ahead two years, the survey results estimated another 10% drop in the minimum asset level where

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fee savings would start being achieved.[2] Of course, the levels that make sense for a specific plan can vary, and among other factors, the plans' service providers and their fee schedules, as well as the extent to which current manager relationships can be leveraged, can be a significant factor in determining the asset level at which a custom approach can be cost-effective. Depending on the approach taken, in terms of both the active/passive mix and the type of administrative arrangement used to implement custom target date options, Rocaton believes certain plans at asset levels below those cited above could realize savings on fees.

Figure 3:
Industry Professionals' Views on Minimum Plan Size for Custom Target Date Strategies

Minimum Plan Size ($millions) to Offer Custom Target Date Strategies

	Total Respondents	At asset manager, no recordkeeping	At firm with recordkeeping	At investment consultancy	At firm that provides custom target date fund services
Average	$517	$682	$326	$347	$654
Median	$250	$500	$100	$100	$250

Minimum Plan Size ($millions) to Offer Custom Target Date Strategies in Two Years

	Total Respondents	At asset manager, no recordkeeping	At firm with recordkeeping	At investment consultancy	At firm that provides custom target date fund services
Average	$468	$622	$296	$302	$651
Median	$200	$250	$100	$100	$200
% Change in Average[1]	-9.5%	-8.8%	-9.0%	-13.2%	-0.5%

1 Two Years From Now vs. Current.

Source: Rocaton / Pensions & Investments "2014 Survey of DC Industry Viewpoints"

Implementation considerations

Although the details are beyond the scope of this paper, plan sponsors should at least be aware of some of the implementation considerations for custom target date funds. Importantly, current providers (recordkeeper and custodian) may vary in how they would implement a custom solution, from technology and operations to communications, and they also vary in how they price such services. Glidepath management and other operational expertise can be provided by third parties that can ease the burden on the client, recordkeeper and/or custodian. Additionally, a custom approach may require participant communication resources that may or may not be included. To the extent the plan sponsor is considering adopting retirement income solutions in the future, compatibility of specific custom approaches with leading retirement income solutions should also be considered. Finally, it is important for the plan sponsor to engage ERISA counsel early in the process as responses have been mixed as to whether a custom application increases or reduces legal and fiduciary risks.

2 Rocaton / Pensions & Investments "2014 Survey of DC Industry Viewpoints"

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Conclusion

Target date fund assets represent a large and growing portion of the defined contribution market. Custom applications are likely to have an increasing share of the market, and therefore, the question of whether to offer custom target date funds is one plan sponsors of all sizes may contemplate. As interesting as the topic of custom target date funds may be, we believe plan sponsors may be able to have greater impact on participant outcomes through initiatives such as those designed to increase participation and savings rates and to facilitate access to age-appropriate diversified portfolios to the greatest extent possible. Assuming plans have addressed these topics, a custom target date strategy would merit further discussion, particularly if a plan sponsor has identified with several of the potential rationales we have outlined above. While Rocaton may suggest a "higher hurdle" for custom target date than some in the industry, there are certainly scenarios in which such an approach will be more likely to help plan sponsors meet specific objectives and in which potential participant outcomes could be favorably influenced.

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