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Are TDFs Subject to Unrealistic Expectations?

John Iekel • 7/31/18

While it’s easy to find a plan that has adopted target-date funds, it’s hard to find assessments that ask hard questions about them. A recent white paper fills that void.

In “Are Target-Date Funds Enveloped by Unrealistic Expectations?” Richard Glass of Investment Horizons asserts that little has been written about how fiduciaries should assess, “on an ongoing basis. whether or not the TDF family they have selected is actually putting their participants on the road to a financially secure retirement.”

There is data available to serve as benchmarks, Glass observes. But he argues that fiduciaries need to look deeper and that they should ask, “Do these readily available benchmarks and analyses provide significant insights as to whether or not a TDF family’s real-world behavior is actually delivering lifelong retirement security to participants who follow conventional wisdom, including contribution levels and investing their entire 401(k) accounts in a single TDF?”

That isn’t all they should do, says Glass. “If fiduciaries are to fulfill their duty of monitoring their TDF family’s effectiveness in delivering retirement security, the fiduciaries must develop their own approaches for answering this question,” he writes. Compounding the problem, says Glass, is that TDF vendors do not help fiduciaries create appropriate benchmarks, adding, “This lack of transparency requires fiduciaries to question the claims of TDF purveyors.”

And that leads to another question, says Glass: “Is it reasonable to believe that a single glide path strategy can deliver the same targeted (as a percentage of final salary) inflation-adjusted retirement income for the typical employee regardless of when — age and year — he starts saving for retirement?

“Fiduciaries also have to ask whether or not they should be concerned that a glide path usually incorporates only to a limited extent an investment guru’s prediction of future capital market behavior and the manager’s ‘ideal’ reactions to unanticipated events,” says Glass. Instead, he argues, “a TDF glide path is primarily an investment manager’s statistical analysis of historical returns (Monte Carlo simulations), biased by his many assumptions and views on risk/return tradeoffs.”

“It is important for fiduciaries to analyze how their TDFs (had they and their 401(k) plans existed) would have behaved in the past,” says Glass. This, he suggests, will help fiduciaries understand:

- the extent to which the returns for the same stock/bond ratios can vary;
- how the same glide path can generate dramatically different account values for participants of the same age who enrolled in their 401(k) plan at different times; and

why the TDF vendors felt they could justify their claims that their TDFs could deliver the desired results.

The major issues that must be overcome if fiduciaries want to use TDFs as their QDIA, says Glass, include:

- Can the fiduciaries define an “average” employee for their company?
- Do the fiduciaries have an appropriate benchmark, or can they develop one, for monitoring their TDF family’s performance?
- How should the value proposition and use of TDFs, including the need for participants to assess their own progress toward retirement readiness, be communicated to participants?
- What tools should the TDF vendor provide participants, and how should fiduciaries evaluate those tools?

“Before selecting a TDF family as their QDIA,” says Glass, “fiduciaries must document that they have both critically evaluated the above issues and know how to address them.” He suggests that evaluation include:

- a description of the process the fiduciaries used to define their company’s “average” employee and an explanation as to why they feel that one hypothetical employee can provide a realistic picture of their workforce;
- a statement as to their TDF family’s purpose: accumulation of an adequate retirement nest egg or the generator of retirement income or both (this paper focuses on the role of TDFs as an accumulation vehicle);
- an understanding of how the glide path — both the stock/bond transition and the assets and asset sub-classes utilized — has changed since the TDF family’s inception date and the rationale for the changes, e.g., reducing downside risk and/or improving alpha (upside potential and/or stabilizing/enhancing the flow of retirement income);
- an assessment of the vendor’s explanation for its TDFs’ performances during the 2008 economic crisis and how “rude awakenings,” if any, were addressed;
- assessing whether or not the participant communications clearly explain that since 401(k) accounts, along with Social Security, will most likely provide the bulk, if not all, of the retirement income for the majority of participants, 401(k) accounts must be managed as mini-DB pensions and not as “run of the mill” savings accounts;
- determining whether or not the TDF vendor is providing fiduciaries and participants with all the assumptions on which the glide path (and thus its POS) is based and the minimum annual compound rates of returns by five-year age bands (starting at age 25) that are required for the glide path to achieve its POS; and
- an evaluation of both the recordkeeper’s and TDF vendor’s calculators.

If fiduciaries are uncomfortable about what they learn through an examination, Glass suggests, that they consider a hybrid QDIA, balanced fund or a managed account as their QDIA. But, he cautions, “When considering replacing TDFs, fiduciaries must recognize that no QDIA is the perfect solution for all employees.”

Furthermore, Glass argues, fiduciaries should recognize that many workers are not “financially sophisticated” and the degree to which they experience financial stress. “Given the low level of financial literacy among 401(k) participants, a strong argument can be made that providing a robust financial education program is a fiduciary duty,” he says.

The Bottom Line

"Prudent decision making requires fiduciaries to establish well-defined processes that address all the issues related to the topics being considered," says Glass. He adds that "fiduciaries should not feel that selecting a TDF family as their plan's QDIA is a 'no-brainer' because most other plans are using them."

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