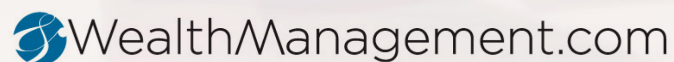
The Role of Target-Date Funds in Your Retirement Plan Advising Practice



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Thanks to their ease of use and ability to help investors maximize risk-adjusted return over time, target-date funds (TDFs) have become an increasingly popular savings option for retirement plan participants–and a valuable tool for advisors who specialize in serving retirement plans. And with TDF use projected to grow, plan specialists with an expertise in these tools will be better positioned to offer guidance to clients on the potential role these funds can play in their portfolios. Leveraging data from a recent survey of retirement plan specialists by WealthManagement.com, this paper addresses a number of topics related to TDFs, including: their value to and use by specialists; the impact of the Department of Labor fiduciary rule on their management; and lingering concerns about their application.

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INTRODUCTION

Over the past decade, target-date funds (TDFs) have become an increasingly popular retirement savings option. Today there is more than $880 billion invested in these products, an increase of nearly 660 percent since 2011. [1]

The structure of TDFs, which maintain an appropriate, risk-adjusted allocation for savers leading up to and through their retirement, makes them a good "set-it-and-forget-it" option for investors. What's more, the products are classified by ERISA as qualified default investment alternatives (QDIA), meaning advisors can select them for clients who have offered no investment direction or input of their own. Those features have allowed TDFs to capture a considerable piece of the DC (Defined Contribution) space.

According to a study by Aon Hewitt [2], 90 percent of defined contribution plans offer target-date funds, with 70 percent of plan participants choosing to invest in them.

Because TDFs are popular tools in the DC plan universe, nearly half of advisors specializing in retirement plans say they use them with their clients. Still, that means half of retirement plan specialists currently are not using TDFs. In some cases, these advisors — or their clients — have questions about their appropriateness. But as TDFs become even more widely available to, and commonly used by investors, plan specialists must take a closer look at these investing options. That way, they can expand their knowledge of TDFs to better serve their clients' interests and needs.

[1] Morningstar, "2016 a Growth Year for Target-Date Funds," January 17, 2017.
[2] Aon Hewitt, "Target-date Funds: Who is Using Them and How Are They Being Used?", March 2016.

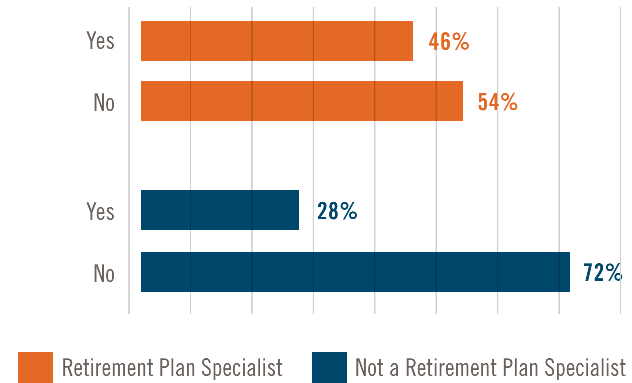
To that end, this report highlights the key findings from a recent WealthManagement.com survey, which asked retirement plan specialists to weigh in on a number of topics surrounding target-date funds. It provides insights into how and why advisors use TDFs with their clients; lingering concerns preventing their wider adoption; and how factors including the recent DOL fiduciary rule could impact their usage going forward.

Section 1: The use of Target-Date Funds

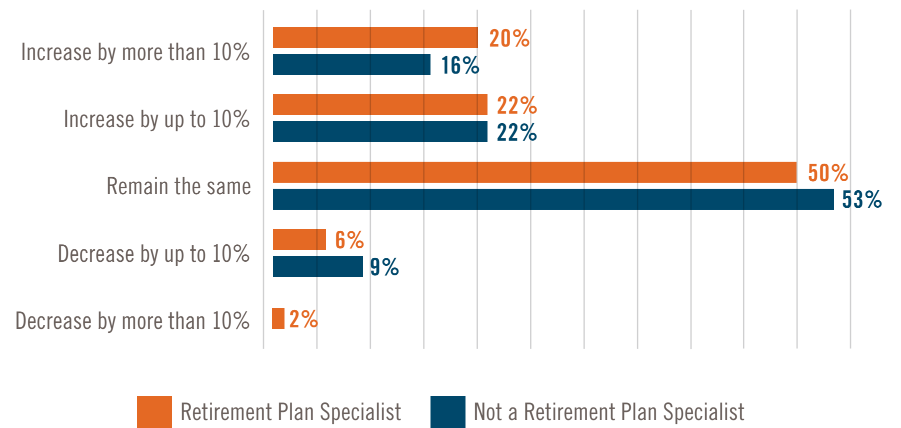
According to the survey by WealthManagement.com, nearly half of all advisors specializing in retirement plans use target-date funds with their clients. Considering the status of TDFs as a QDIA and their popularity in defined contribution plans, that high rate of use among specialists is understandable. And the trend is unlikely to reverse: More than 90 percent of retirement plan specialists say they expect to either maintain or increase their use of TDFs in the future **(Figure 1)**.

FIGURE 1: Usage of TDFs between Retirement Plan Specialists and Other Financial Advisors

Do you currently use Target-Date Funds (TDFs) with your retirement plan or individual clients?



How do you expect your use of TDFs to change over next two years?



Section 2: The Value of TDFs

The adoption of TDFs as an investment vehicle during the past five years can be attributed in part to their ability to address the key risks facing retirement savers. According to the retirement plan specialists surveyed, the leading challenges that clients face in reaching their retirement goals are volatility risk and longevity risk — two threats that the vast majority of specialists say target-date funds are effective at managing.

To help protect against volatility, TDFs provide investors with a diversified portfolio that automatically rebalances its allocation to become more conservative over time. But even as a TDF investor enters retirement, many funds maintain some exposure to stocks, providing growth potential to protect the investor from outliving their savings. In fact, more than two-thirds of specialists surveyed recommend this type of "through retirement" glide path to their clients, maintaining greater equity exposure later into life and allowing them to use the same fund throughout the accumulation and drawdown periods **(Figures 2 & 3)**.

FIGURE 2: Which is the biggest risk to successful retirement outcomes?

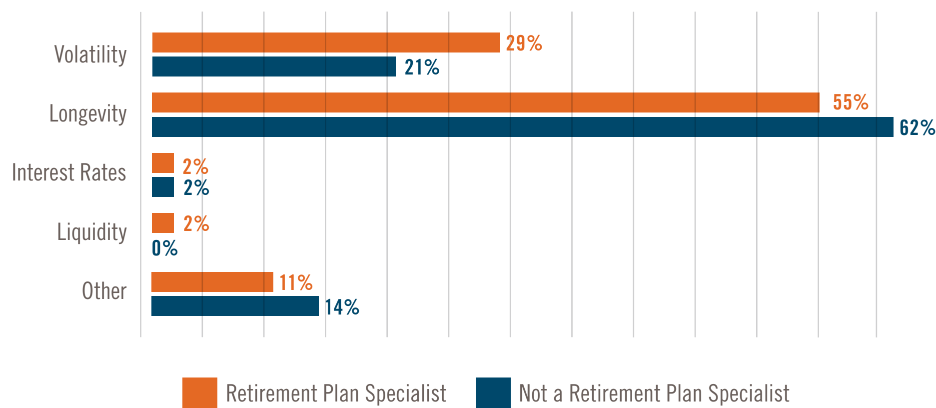
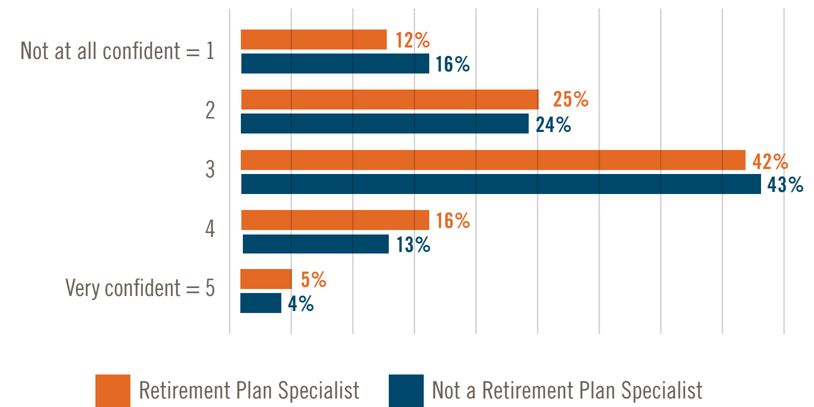


FIGURE 3: How confident do you feel about target-date funds' ability to manage risks in clients' portfolios?



Section 3: Concerns About TDF Use (from Plan Specialists and Investors)

To uncover why just over half of plan specialists are still hesitant to use target-date funds, we asked survey participants about the major questions and concerns they — and their clients — had about these funds.

According to advisors specializing in retirement plans, the leading factor discouraging them from using TDFs was the lack of customization available. That complaint is understandable: While most off-the-shelf TDFs provide an appropriate array of solutions for the average investor, investors with more unique needs may need more complex options. For instance, these investors might benefit from access to a wider range of asset classes, external fund managers, and individually-tailored glide paths available only through custom funds. As the demand for those advanced features has increased, so has the number of options available in the custom TDF space. It stands to reason that the trend will continue.

However, plan specialists interested in custom TDF options for their clients should be prepared for an increased fiduciary responsibility that can accompany those types of funds. More complex solutions — including the use of alternative investments in the underlying funds and the inclusion of an active, outside investment manager — can result in more scrutiny from regulators and require additional oversight on the part of the advisor.

While specialists are concerned about their ability to tailor TDFs to their clients' needs, their clients are more concerned with the fees the funds charge. The average expense ratio of a TDF was 0.73 percent in 2015—almost 10 basis points higher than the average index fund.[3] But those fees have fallen by roughly 30 basis points over the past five years thanks to an increasingly competitive product landscape and demand from clients for lower-cost options.[4]

Even with pricing becoming more competitive, it's still important for plan specialists to understand and be able to communicate to clients why TDFs charge the fees that they do. One reason for higher fees is that the investor is paying a premium for a fund manager to select and regularly rebalance the assets in the TDF. What's more, the fund might give a client access to asset classes or investments otherwise closed to them because of net worth or minimum investment requirements. And that access comes at a price.

Retirement plan specialists should be able to assess the value of those benefits and determine whether the fund series' performance relative to its benchmark — and its expenses — justify the fees associated with it. In fact, specialists say that under the Department of Labor's recent fiduciary rule, fees are the top factor they need to consider when evaluating whether a TDF is appropriate for a client **(Figures 4 & 5)**.

[3] Investment Company Institute, "Retirement Assets Total $25.3 Trillion in Fourth Quarter 2016," March 22, 2017.
[4] InvestmentNews, "Retirement specialists have outsized influence in adviser-sold DC market," September 16, 2015.

FIGURE 4: Reasons for not using TDFs

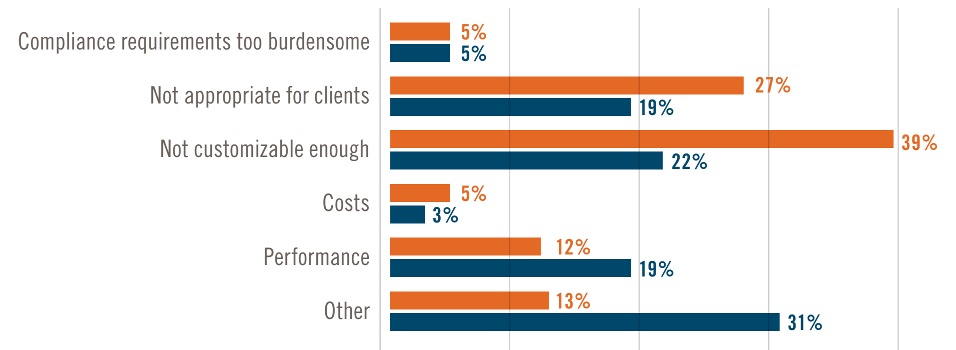
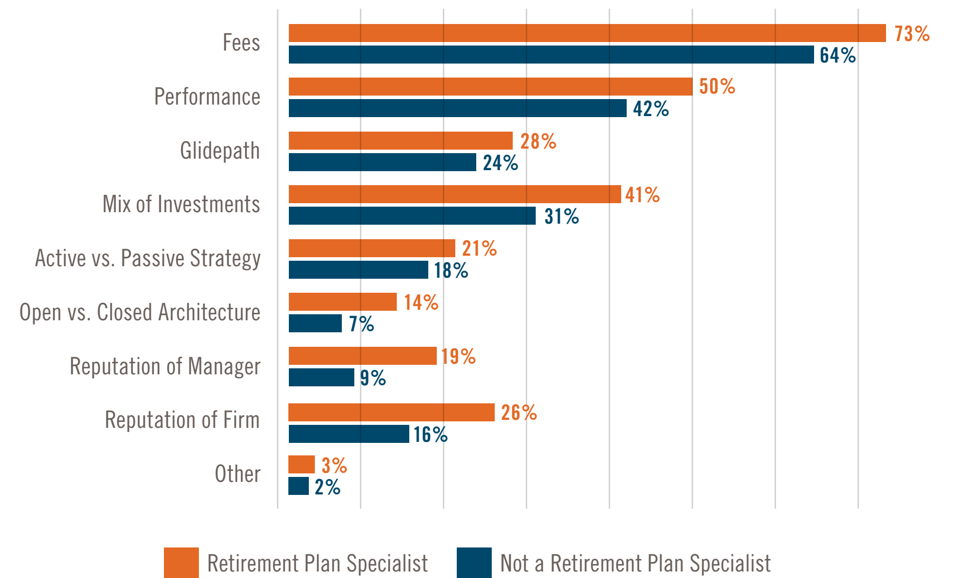


FIGURE 5: Most Important Factors when considering a TDF



Section 4: The Impact of the Department of Labor Ruling

The impact of the adoption — and potential repeal — of the Department of Labor's fiduciary rule has been a major source of concern and debate for the advising industry. But 73 percent of plan specialists said the DOL guidance had no impact on their likelihood of using TDFs. What's more, 87 percent of retirement plan specialists said regulatory change under the new administration also would have no impact on their use of target-date funds.

Nearly 80 percent of specialists consider themselves either well-versed or experts in their understanding of the new fiduciary standard. That familiarity with the rule might explain why fewer than one-third of specialists have serious concerns about the impact of fiduciary issues surrounding their use of TDFs.

Where the DOL rule has had an impact on TDF use, say specialists, is in the way they must document the process of guiding clients into these investments. While TDFs can help simplify the retirement saving process for investors, they do so through rather complex structures. Not only can those structures be complicated for investors to understand, but different fund series can produce very different outcomes. From a fiduciary standpoint, that makes the process of evaluating whether a particular TDF is appropriate for an investor a critical one. And documenting each step of that process — from evaluating the client's needs, to assessing the quality of the underlying funds — is good practice to ensure that any TDF recommendation is made in line with the DOL's guidelines.

To that end, 58 percent of specialists say that they use an Evaluation Process Statement, a document that shows the work they've done to select a particular fund, and how they will regularly revisit/evaluate its suitability for the investor **(Figures 6 & 7)**.

FIGURE 6: Where has the DOL guidance rule had the greatest impact on your process?

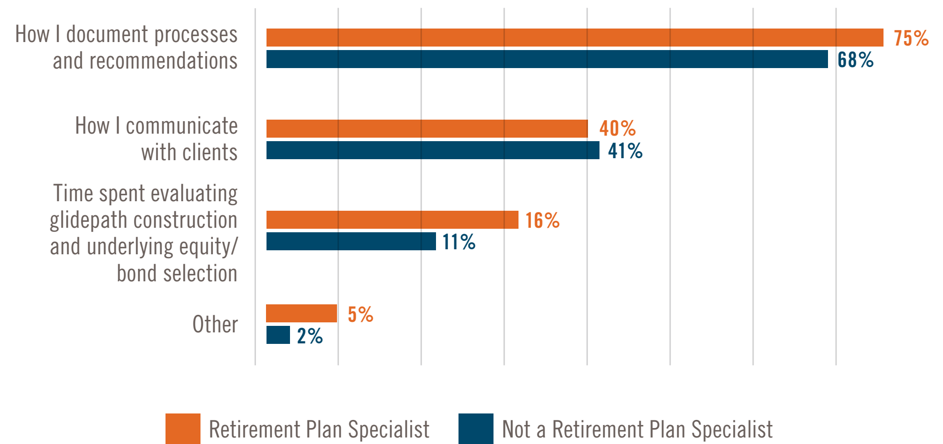
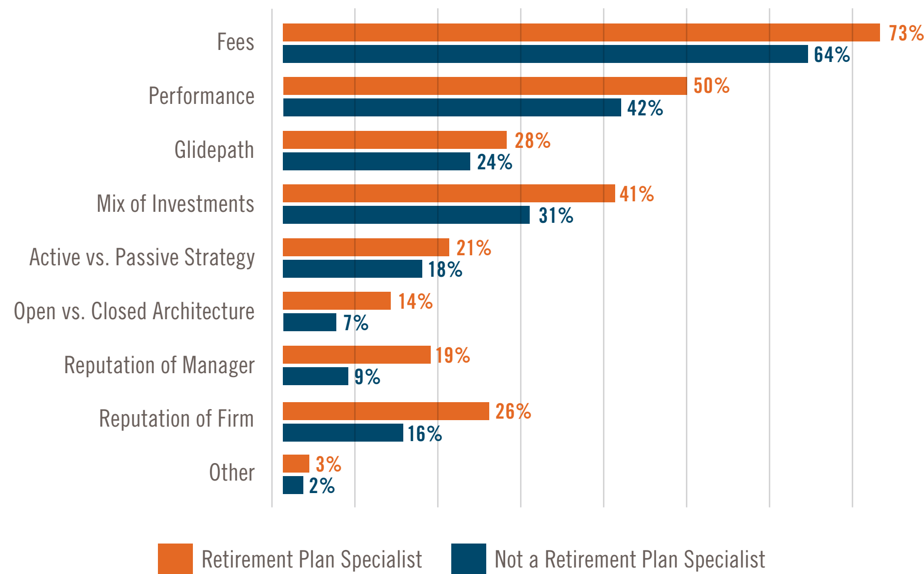


FIGURE 7: Under the new DOL guidance, which of those factors do you anticipate will be the most important when considering a TDF series?



Learn more about our sponsor, T. Rowe Price, by visiting **trowprice.com/adjustments**.

Learn more about Target Date Funds from our sponsor, T. Rowe Price:

- **Five ways to talk to plan sponsors about their fiduciary process**
- **Sensibly Reframing "To Versus Through"**
- **Target Date Strategies: The Benefits of the T. Rowe Price Approach**

TOP TAKEAWAYS

As target-date funds capture a greater share of the retirement plan market, it's increasingly important for retirement plan specialists to understand these options, know how to evaluate their suitability for clients, and make informed recommendations about their use. The retirement plan specialists who are already using target-date series with their clients say that the work is worth the effort: that TDFs are effective at managing the most pressing risks facing investors, and at maintaining an age-appropriate allocation that limits exposure to volatility while also promoting growth.

And as demand for both off-the-shelf products and more customizable options increases, retirement plan advisors have access to a range of funds to meet their clients' unique needs. However, advisors looking for those more tailored solutions should be aware of, and proactive in addressing, the heightened regulatory oversight that accompanies those products. That attention to detail and transparency is critical in TDF selection as well. The complexity of target-date funds' underlying structures requires advisors to develop a well-documented evaluation and selection process. Regardless of when (or if) the DOL ruling is put into effect, retirement plan specialists using TDFs with clients should have a written Evaluation Process Statement outlining the analysis behind their recommendations. That way, they can demonstrate their detailed understanding of TDF options, as well as their careful assessment of client needs in order to find an appropriate solution.