

October 24, 2008

Fiduciary Corner

by James R Sotell, AIF®

The recent market volatility has affected many 401(k) plan participants. In addition, many Plan Sponsors, over the last two years, changed their *default option* from the money market or stable value fund to a lifecycle or target date fund.



As we know, the main reason for the default fund change was the Pension Protection Act of 2006 (PPA), a key provision of which was the QDIA (Qualified Default Investment Alternative). The QDIA enabled Plan Sponsors to reduce their fiduciary liability by selecting a “balanced” default option for those participants who did not make an investment election. This balanced portfolio included stocks, bonds and short-term instruments. The three types of QDIAs are (1) target date fund, (2) balanced fund or (3) managed account option.

Although all three are viable, the overwhelming choice for many Plan Sponsors has been the lifecycle or target date funds. This may seem like a simple and straightforward decision. It is critical that a fiduciary process has been followed in rendering your default fund decision. Some questions a Plan Sponsor needs to ponder are:

- 1) Did the Plan Sponsor engage in a prudent process of evaluating all the available QDIA options?
- 2) Does the Plan Sponsor have documentation of that due diligence process either through meeting minutes or separate memo?
- 3) What ongoing process is utilized to monitor the default option?

The key with any investment decision is *process and documentation* as we discussed in our last edition. This standard applies to all investment decisions including the default option. Our experience is many Plan Sponsors have elected their QDIA default fund but do not have any documentation to show they went through a prudent process. This documentation is necessary and we recommend Plan Sponsors have either a memo or meeting minutes discussing the process they undertook in evaluating and selecting their QDIA.

From an investment perspective, the evaluation of target date funds is more complex than it may appear. At first glance, it may appear that all target date funds are similar since they are being managed toward the same retirement date. In fact, these funds can vary greatly. The composition of similarly-aged funds can be quite different from an allocation perspective (stocks/bonds/short term instruments). For example, I recently saw a chart that illustrated how dramatic the differences in equity exposure were for the same vintage funds. For example, the equity exposure in the different Target Date 2025 Funds ranged from a low of 20% equity to a high of 95%.^[1] This vast difference in equity exposure is significant in two ways: (1) *selecting* target date funds by investment returns can be misleading. The reason is

higher equity exposure funds are much more sensitive to movements in the overall stock market. They may have better performance when the stock market is up and worse performance when the stock market is down. This issue has been magnified recently. Target date funds that were top performers in 2007 are now bottom quartile performers in 2008. Therefore, those Plan Sponsors that relied solely on performance may be experiencing more volatility and negative performance than they anticipated.

(2) *Benchmarking or monitoring* target date funds on an ongoing basis vs. peers can be misleading. For the same reasons outlined above regarding equity exposure, it will not provide a true evaluation of how that fund is performing relative to its asset allocation. Rather, we recommend benchmarking your target date funds to a custom benchmark. This custom benchmark is a weighted index that matches the equity/bond and short-term allocation of the fund. This will allow you to see if your target date fund has added value over the *custom benchmark* by stock selection (the underlying funds being used). Many target date funds will provide a custom benchmark for their funds.

The target date fund industry is evolving and it is critical that Plan Sponsors understand how their funds are constructed (equity/bond/ short-term instruments) and how the equity is reduced over the life of the fund. This reduction of equity and increase in bonds and short-term instruments is called the glide path. Some glide paths have participants maintain large equity exposure at retirement. Their reasoning is longevity risk (participants will live longer). You need to assess if that strategy or equity exposure is acceptable for your employees. This is the stomach factor.

Plan Sponsors need to be aware of all these issues on the target date funds. Target date funds and QDIAs will be tested in this tough market environment. It once again reinforces the strong need Plan Sponsors must undertake in the evaluation, selection and monitoring of all their investment options.

[1] Chart furnished by Fidelity Investments. It was comprised of the ten largest lifecycle (target date) fund families by net flows in 2008 through 7/31/2008. Data provided by fund prospectuses and Strategic Insights as of 7/31/2008.