USI ADVISORS, INC.

TARGET DATE FUND SELECTION: ACTIVE VS. PASSIVE

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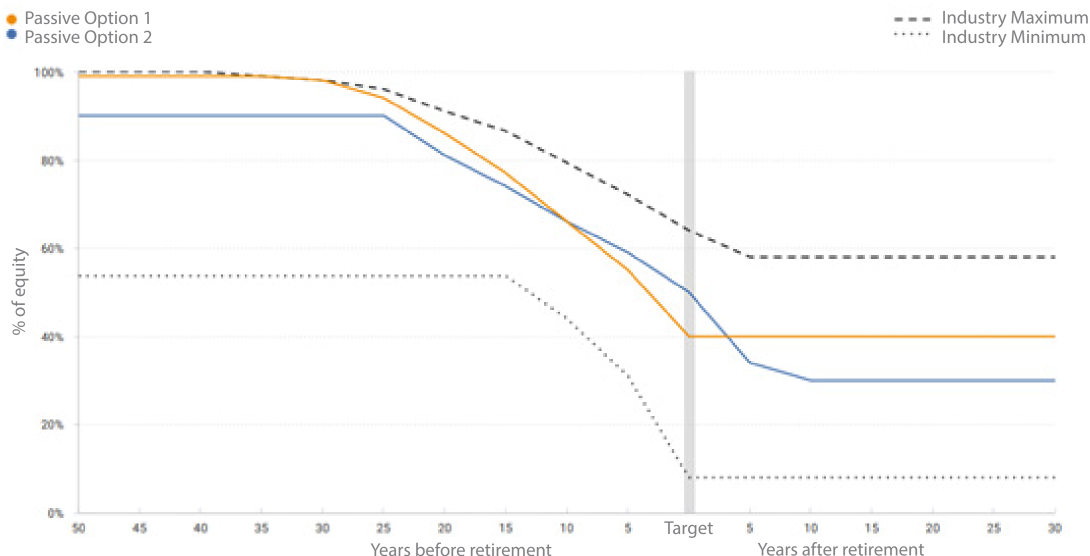
Target date funds dominate as the primary Qualified Default Investment Alternative QDIA option in Defined Contribution plans. Their popularity has coincided with DOL's increased emphasis on managing plan costs and an increase in the number of fiduciary lawsuits surrounding excessive fees. The fee pressure has pushed plan sponsors towards passive target date products based on their lower cost structure. In 2018, nearly all net flows to target date funds went to investments with 80% of assets held in index funds.[1]

Cost is an important consideration, but it should not be the only one. Going with the lowest cost provider does not alleviate plan fiduciaries of their due diligence responsibilities in finding a target date provider that aligns with the participants' specific needs. In other words, if the target date fund glidepath is a poor fit for the plan demographics, low fees will not necessarily be in the best interest of participants. A few features to consider as part of a prudent selection process include glidepath construction, asset class exposures, active/passive management and type of investment vehicle (CITs, mutual funds etc). Let's explore some of these attributes in more detail to see how they may impact a participant's investment experience over their career.

Glidepath Construction

Not all target date funds are built the same. They can have varying risk/return profiles based on specific glidepath design decisions. Two target date providers may have different beginning and ending allocations and varying equity exposures over the course of a participant's career. It is important to consider how the asset class exposures shift over the glidepath and how quickly the equity portion slopes down as well as the number of years it takes the glidepath to roll down after retirement. **Table 1** highlights an example of two passive target date providers, both having indexed underlying fund exposures. Passive option 1 starts with almost 100% exposure in equities at the beginning of the glidepath and reaches the most conservative point at age 65 with 40% in equities. Passive option 2 starts with 90% invested in equities and holds as much as 50% in stocks at retirement age and continues to roll down the equity portion another 10 years past retirement before hitting the most conservative point in the glidepath with 30% in equities. Ultimately these asset allocation differences can have a significant impact on both risk and return for the employees utilizing the products. It is important to identify an appropriate glidepath for the specific participant population.

Equity Glide Path Comparison



Source: JP Morgan Target Date Compass

TABLE 1

[1]Morningstar's 2019 Target Date Landscape

Perhaps one of the most important sections of the glidepath is the years leading up to retirement since this is where most providers have substantial differences in their equity exposures. This is also a critical point for participants close to retirement and there is a higher risk of them reacting emotionally, especially during a down market.

Active, Passive and Blend

Active target date providers typically seek to add value by making tactical asset allocation decisions on the glidepath based on changing market conditions. Most passive providers don't have the same flexibility and typically maintain the same glidepath over time. At the fund level, a fully passive approach provides the benefit of lower fees based on underlying index exposures but can limit certain glidepath decisions. Certain asset classes may be difficult to replicate in an index strategy, eliminating the diversification potential of the portfolio. Additionally, the decision to select a broad market index or market cap index may lead to other differences in performance. In the case of a fully active strategy, there are other limitations to consider. The expectation is that the underlying managers will add value after fees. The risk with this method is that the manager may underperform their respective benchmark due to poor stock selection or allocation decisions. In recent years, we have seen some plan sponsors implementing a target date approach that combines both active and passive styles. Active managers are utilized for their return seeking opportunities in less efficient markets where they have historically outperformed while low cost index funds are used in more efficient asset classes. A blended approach is seen as a way to reduce fees while giving a manager flexibility to adjust the risk levels at different parts of the glidepath.

Sub-Asset Class Exposures

It is also important to consider the allocation mix of the asset classes being utilized and any exposure to non-traditional categories. There might be asset class differences that impact the degree of diversification of the series. Typically, active target date providers have the flexibility to allocate to any liquid capital market and they have targeted exposures while their passive counterparts may lack exposures to certain asset classes that may be too costly to replicate. For example, there are significant differences among fixed income asset classes. Active target date funds include non-core fixed income categories in order to achieve a higher yield and further diversification. They typically include asset classes such as bank loans, emerging market debt and high yield, while their passive counterparts typically allocate primarily to the intermediate-core asset class. Differences exist even among passive target date providers. In the example above, both passive series' lack exposure to emerging market debt and commodities. Passive option 1 allocates to real estate while option 2 does not. Further, option 2 allocates to high yield and international fixed income, while option 1 does not. These differences can translate into different degrees of diversification and meaningful risk and return variances for participants utilizing the funds.

Choosing between an active vs. a passive target date series is an important decision for a plan sponsor, but as noted earlier, the differences between these two approaches go beyond cost. Active decisions on glidepath design and asset allocation have more impact on a participant's investment experience than the cost differential between active and passive underlying exposures in the target date series. As part of a prudent due diligence process, plan sponsors should review their existing target date provider against these features to find one that best aligns with plan needs such as demographics, time horizon and investor risk tolerance. Ongoing monitoring is also necessary to ensure that the glidepath continues to support the goals and objectives of the plan.

For more information please contact your Investment Consultant or email us at USI.Advisors@usi.com

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