

## Are Single-Manager Target-Date Funds Risky For Large Plan Fiduciaries?

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### Single-Manager or Custom Target-Date Funds: Which Has the Fiduciary Advantage?

For large defined contribution (DC) plans, a custom target-date portfolio is likely a more prudent choice than an off-the-shelf single-manager target-date fund. A custom target-date fund is “open-architecture” and differs from a single-manager fund in two important ways – the asset allocation is designed to match the specific objectives and demographics of the plan, and sponsors are free to use their preferred underlying managers, including those that manage existing core options in their DC lineup or possibly manage defined benefit assets.

A custom target-date portfolio removes a potential provider conflict of interest by separating the asset allocation function from the underlying component management function, ensures the target-date fund asset allocation aligns with plan circumstances and enables changes to the asset allocation or underlying investment manager mix to maintain best practices while minimizing costs.

A single-manager target-date fund offers none of these advantages. Any change made to the target-date fund by the provider impacts participants, regardless of whether the sponsor believes the change is in the best interests of participants. If a plan sponsor is unhappy with any aspect of the management of a single-manager fund, there is nothing the sponsor can do—short of moving to a different target-date provider. Worse, if the record keeper also happens to be the incumbent single-manager target-date fund provider, it may not allow the change, forcing the plan to move to a new record keeper at great disruption and expense.

For these and other reasons, custom target-date funds are becoming commonplace in large DC plans. Indeed, we believe single-manager target-date portfolios serving as default investments pose potential risks to fiduciaries of large plans when better choices are available.

### The Target-Date Wave: A Challenge of Choice for Fiduciaries

Target-date portfolios were developed to address a major challenge for DC plans: most employees have neither the skill nor desire to devise a diversified, age-appropriate asset allocation strategy. Despite extensive investment education campaigns from plan sponsors, the problem persisted—many participants needed more help.

According to AllianceBernstein's research, about two-thirds of participants are “accidental investors” who describe themselves as unable or unwilling to make their own investment decisions. Accidental investors prefer simple solutions that remove the burden of choice, and target-date portfolios offer that simplicity by providing premixed asset allocations designed and managed by investment professionals who rebalance the portfolios, taking less risk as participants age.

The Department of Labor (DOL) recognized the appropriateness of target-date funds for long-term retirement investing when it established them as a Qualified Default Investment Alternative (QDIA) in 2007. The QDIA classification offers plan fiduciaries the protection of a safe-harbor provision under the Pension Protection Act of 2006 (PPA) that states that fiduciaries are not liable for losses which occur as a result of participants being defaulted into target-date funds. Given target-date funds' broad appeal, many

sponsors are considering or have already selected them as a QDIA.

The appeal of target-date funds has led to an explosion in the number of available target-date fund offerings and has left plan sponsors with the daunting task of sifting through a dizzying array of choices. Confronted with overwhelming choice, it is not surprising that many plan sponsors have been attracted to the simplicity of selecting a single-manager target-date fund designed, managed and delivered by a single provider who is very often (and not coincidentally) their record keeper.

### **Custom Target-Date Funds: An Evolving Large-Plan Standard**

In single-manager target-date funds, a single manager determines the asset allocation, manages all the underlying asset classes and delivers the investment strategies in a mutual fund or collective investment trust that is also under the manager's control. Many plans selected a proprietary single-manager target-date fund as their default option following passage of the PPA—not only was a proprietary fund a simple and time-efficient choice among broader plan changes ushered in by the PPA, but a proprietary fund may have been the *only* choice available through their record keeper at the time. And disappointing recent performance and current government scrutiny of target-date provider practices have left many fiduciaries wondering whether a proprietary single-provider fund is appropriate for their plan.

The target-date landscape has changed in the past few years, however, and sponsors now have choices beyond their record keeper's proprietary funds. Service providers are offering custom "open-architecture" target-date funds where an independent fiduciary tailors the asset allocation to the plan's circumstances while different investment managers are responsible for the underlying asset class strategies. Importantly, a custom structure gives control to the plan fiduciaries which enables them to evolve the target-date fund over time, including changing the asset allocation and investment manager lineups, which is not possible with a single-manager structure.

We believe using a custom target-date fund as a QDIA will become standard practice in large

plans. This trend is already well under way: according to a recent survey<sup>1</sup>, 33% of plans with greater than \$1 billion in assets have already implemented custom target-date funds. In the minds of the fiduciaries for these plans, custom open-architecture target-date funds are likely to deliver better participant outcomes, making them a more prudent and less risky choice than single-manager, often proprietary funds.

### **Single-Manager Target-Date Funds May Pose Risks to Fiduciaries**

Despite the readily apparent advantages of custom target-date funds, some plan fiduciaries may believe that a custom target-date fund creates risks for them, since it involves them in selecting an asset allocation provider and managers of the underlying asset-class components. They reason that by sticking with a single-manager fund, they can avoid these responsibilities—and risks.

We don't agree with this assessment.

Selecting a single-manager target-date fund does not relieve fiduciaries from the responsibility of evaluating the quality of asset allocation providers or managers and strategies in the underlying asset classes. Projections showing that most assets in a typical plan will be invested in a QDIA within several years of its adoption underscore the importance of a prudent target-date selection. We believe selecting a single-manager target-date fund as the plan default presents four significant risks to the plan that are not present in custom target-date funds.

First, the plan takes on substantial manager concentration risk—not only will the plan assets be directed to the underlying component strategies by a single manager, but the same manager will actually invest all of the components. It is unlikely that the same manager is the best choice in every asset class. Worse, if the provider does not happen to manage a strategy in a particular asset class, the target-date fund will simply have no allocation to that asset class, even if it might be a prudent allocation.

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<sup>1</sup> Casey Quirk & Profit-Sharing / 401(k) Council of America Target-Date Retirement Fund Survey, Summary Findings for Participants, June 18, 2009.

Second, a single-manager offering has a predetermined asset allocation strategy that does not account for specific plan circumstances. While diligent evaluation could lead plan fiduciaries to select a target-date fund with an asset allocation strategy deemed to align well with plan circumstances, the plan sponsor is left with the risk that the provider may, at any time, alter the asset allocation—as many have over the past few years—in a manner that may not be desirable or in the best interests of participants.

Third, the plan has no ability to alter the asset mix or replace an underlying component manager, even if it would be prudent to do so. While the plan could always replace the entire target-date fund structure, such a change is reactive, time-consuming and expensive—and if the plan adopted a different single-manager target-date fund structure, it could find itself facing the same decisions again in the future.

Finally, single-manager target-date funds may be more expensive than custom open-architecture structures, which promote competition among investment managers and allow large plans to leverage their asset base to secure lower fees, typically by using vehicles such as collective investment trusts or separate accounts.

For all these reasons, few large institutional investors, such as defined benefit plan sponsors, would entrust all of their assets to a single manager—and relinquish control of those assets. If a defined contribution plan is large enough that a custom target-date structure is economically comparable to single-manager target-date funds, passing up the benefits of open-architecture could pose risks to fiduciaries, as an ever-increasing share of plan assets reside in the single-manager target-date fund particularly if it is managed as a proprietary offering of the plan's record keeper.

### **Plan Sponsors' Duty in Target-Date Selection and Monitoring**

To understand why this may be the case, it helps to review the fiduciary's duty in selecting and monitoring target-date funds.

Under the general fiduciary standards of the Employee Retirement Income Security Act (ERISA), fiduciaries must select target-date funds prudently, just as they're required to do with any investment option. As ERISA puts it, fiduciaries

must act “with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”<sup>2</sup>

The implication for target-date funds: even though they're among the QDIAs listed in the Labor Department's default investment regulations, plan sponsors still have to prudently select and monitor them—and that *includes* not only the asset allocation, but also the underlying investment components. As a DOL official described it, among the things fiduciaries would analyze to fulfill their fiduciary duties is “the portfolio of the funds in which participants will be invested.”<sup>3</sup>

Fiduciaries who omit this analysis may not be fulfilling their fiduciary responsibilities—whether their target-date fund is single-manager or not.

### **Custom Target-Date Funds: Better Expected Outcomes for Participants and Sponsors**

We believe that custom target-date funds can actually help fiduciaries fulfill their obligations. Plan sponsors and their consultants can choose what they believe are the best investment managers for each underlying asset class, and can even build target-date funds using managers that are already on the plan's investment menu—managers that presumably have already been evaluated prudently for manager quality and are being monitored.

For example, if a plan's menu already includes an international equity fund managed by AcmeCo, fiduciaries would already have performed the due diligence on AcmeCo and been satisfied that it was a prudent selection. We don't believe that using AcmeCo to manage the international equity portion of a custom target-date fund would pose any additional fiduciary risk.

On the other hand, if the international service in a single-manager target-date fund managed by

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<sup>2</sup> ERISA Section 404(a)(1)(B)

<sup>3</sup> Testimony of Robert J. Doyle, Director of Regulations and Interpretations of the Employee Benefit Security Administration, before the ERISA Advisory Council Working Group on Hard to Value Assets and Target-Date Funds, July 15, 2008.

FundCo isn't as strong as AcmeCo—or worse, if FundCo's international equity option had actually been removed from the investment menu due to performance concerns—participants should rightfully question the prudence of FundCo continuing to manage the international equity portion of the target-date funds.

Custom open-architecture target-date funds allow plan sponsors to remove and replace underperforming asset-class managers easily—flexibility that doesn't exist with a single-manager target-date fund. The asset-allocation strategy of a custom fund can also evolve as plan circumstances or market conditions make changes prudent. These responsibilities can be easily and cost-effectively transferred to fiduciaries willing to perform asset allocation or manager selection and monitoring, with the sole focus of devising the highest quality target-date fund strategy for the plan. A single-manager fund provider, on the other hand, might retain or

change its asset mix or manager lineup for business reasons that have little to do with the plan's needs.

We don't mean to suggest that single manager target-date funds can't be prudent choices for plan fiduciaries—they can. For smaller plans, these structures may be the only economically viable target-date option, and fiduciaries who follow a prudent process could hardly be said to be breaching their ERISA obligations by selecting them. Importantly, plans should follow and document the same process as they would to select any investment option, placing special scrutiny on any proprietary option promoted by their record keeper. However, if a plan is big enough to justify custom open-architecture target-date structures, there are many compelling reasons for fiduciaries to consider them, including the avoidance of potential risks latent in single-manager funds.

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