
Advisor Q & A

TDF Monitoring

Selecting a prudent qualified default investment alternative (QDIA) is one of the most critical decisions for defined contribution (DC) plans. Research shows that the majority of assets in DC plans today are invested in the QDIA, and most of those assets are invested in target-date-funds (TDF). That percentage is only expected to grow over the coming years. Given the heightened focus on the QDIA, many retirement advisors already have an established, thorough TDF selection process. However, in speaking with top advisor teams in the industry, we have learned that many would benefit from more guidance on how to establish and conduct an ongoing TDF monitoring process. In fact, advisors are wise to heed the Department of Labor's (DOL) Tips that were released in 2013 stating that DC Plans need to "establish a process for periodic review of target-date-funds."¹

In this Q&A, we reveal some insights on the topic as shared by senior leaders from top retirement firms serving DC plans in the U.S. today: Chao & Co, Innovest, Lockton, SageView Advisory and USI Consulting.

PIMCO: Do you currently have a TDF monitoring process in place? If so, what is the basic structure of this process?

Chao & Co.: Yes, we do have a systematic target date fund monitoring process in place. It is important to recognize that the initial selection process is very much tied to the monitoring process. We have an exhaustive TDF selection process which truly customizes the target date option based on elements including the Plan objectives, demographics, and the Plan Sponsor's understanding of multi-asset portfolio construction and asset risk/return ranges. After we complete our client-specific selection process, we conduct a review in writing, each quarter. If there have been any material changes to the TDFs since the Plan first invested, then a deeper dive would be necessary. We also document our prudent selection and monitoring process as a distinct portion of the investment policy statement (IPS).

USI Consulting Group: Our monitoring process is ongoing. We evaluate a target date fund series by applying our proprietary scorecard and 5P framework on the investment universe. Our 5P framework includes continuous due diligence on the people, philosophy, process, performance and product design of the series. This is conducted on a monthly, quarterly and annual basis. On a monthly basis, we will generate quantitative metrics through our proprietary scorecard, which extends on a quarterly basis to also include in-person manager due diligence reviews. The annual review is more holistic. Many firms release their Capital Market Assumptions in the second half of

the year, which we find an optimal time to capture any changes or investment trends. We combine this investment focused review with an in-depth review with the client on the plan's demographics, design features and participant behavior, and its alignment with their investment policy statement objectives. We believe that glide path design, coupled with underlying investment manager selection and performance, are key areas of focus when evaluating target date fund series.

Lockton: Our current monitoring process involves both a comprehensive annual target date fund review and a quarterly review focused more heavily on performance. In terms of quarterly performance reviews, we have created a TDF scorecard to capture and measure performance. If a portfolio performs below expectations, we will monitor the TDF more closely to see if it needs further review, or to be placed on a watch list. We do not have a set time period for a watch list, rather we continue to monitor the TDF and determine whether there is reason for it to be removed from the watch list or replaced in the plan. The annual review looks more broadly at the plan objectives for the TDF and the ideal glide path and construction, considering benefits design and employee demographics. We evaluate how well the current TDF aligns with the stated goal and objectives and we conduct a deep comparison against other TDFs with similar glide paths and construction.

What is your view on the role of plan demographics when it comes to target-date-fund monitoring?

Innovest: We feel strongly that plan demographics are important when you are going through the initial selection process. Generally speaking, from a monitoring perspective, we have found that Plan demographics do not shift dramatically or often enough to have a significant impact on the QDIA option. For example, certain companies we work with have forced retirement at age 55, so this fact is taken into account at the point when we are initially selecting a target date fund. However, on an ongoing basis, these demographics will not shift dramatically year after year to impact the QDIA. That being said, in the event a plan does experience demographic changes, we would re-assess the TDF option accordingly.

Sage View: We believe a review of the demographics should be part of the ongoing monitoring process. As demographics shift over time, it is important to make sure the QDIA option aligns with the needs of the plan participants. Therefore, we have built a proprietary system that enables us to periodically evaluate the implications of demographic changes on the TDF glide path decision and document the decision for our clients' fiduciary files. We see the TDF decision as one component in building a holistic strategy for retirement plan success. Demographics are an important input into this decision, but we also need to account for other factors, such as plan design provisions and sponsor objectives for the plan.

USI Consulting Group: We believe that the role of plan demographics is an important input to the selection and continuous monitoring of a target date fund series for a plan. We review the variety of target date fund series that are available, and

present what we believe is the best option for the plan's participant population based on participant behaviors, plan provisions and investment objectives. We utilize specific tools to help plans in selecting a target date provider. It is an optimization report that we generate to identify a glidepath that fits the plan demographics. Three sets of inputs are taken into account: 1) employee inputs (average income of the participant, average age, retirement target age etc.), 2) savings inputs (plan's participation rate and savings rate of the average participant, income replacement target in retirement etc.) and 3) risk inputs (average risk tolerance, average investment knowledge etc.). Conducting this analysis helps to identify an investment strategy and target date fund series that is aligned with the Plan demographics and objectives.

Lockton: Understanding plan demographics is an important part of the initial target-date-fund selection, but we also believe you must be careful with QDIA decisions based on plan demographics. There are limitations that you have to be aware of when analyzing the data. Employee groups with significant prior work history, short job tenure, or high likelihood of outside assets will all have financial situations that may vary significantly from the picture shown in the plan demographic data. We also believe other aspects, such as plan design features, other benefits and risk tolerance are very important. The utilization of a target date fund by participants will depend on plan design features such as auto-enrollment, re-enrollment, and auto escalation and can be influenced by other benefits like a legacy defined benefit plan or a stock program.

Benchmarking target-date-funds can be a challenge and there are various approaches to this part of the monitoring process. Please describe your views and approach to benchmarking TDFs.

Chao & Co.: We have seen the application of a traditional, single asset class, static benchmarking approach to multi-asset portfolios that evolve over time. In our opinion, this is a deficient application for a multi-asset portfolio. Given the nature of target-date-funds and how vastly different each glide path is based on its unique objectives, strategies and beliefs, it is seldom appropriate to use peer rankings to benchmark multi-asset portfolio performance (particularly actively managed). Additionally, most industry benchmarks take an average across target date funds per vintage approach, or create an arbitrary glide path as the benchmark, which also would be deemed inappropriate for benchmarking purposes. Therefore, from our perspective, once a plan has selected a target date fund, the appropriate benchmark is the fund's own glide path. Once you have identified an appropriate TDF for the plan, comparing it to other TDFs with different goals, objectives and glide paths or a broad universe of strategic glide paths would be insensible. The question really becomes, "how did the TDF perform relative to its stated goals and objectives?" Accordingly, the selected TDF's glide path is the most appropriate benchmark or the best fit to evaluate performance.

Sage View: We presently assess TDF performance relative to industry peers and each manager's custom benchmark. TDFs are investment products just like any other mutual fund, and while suitability factors are especially important in this space, there are

nevertheless some TDF managers who will execute well on their strategies and others who will not. TDF managers employ a wider decision-making tool set than most single asset class fund managers, and strategic asset allocation decisions are particularly important performance drivers. We believe it is our job to gauge the effectiveness of each TDF manager in delivering value to investors, regardless of the return source. This is where peer group-based assessment can be useful. While it has certain inherent limitations in the TDF space, peer group-based assessment can help determine if a manager's collective long-term asset class decisions are impactful, which we feel is difficult to do through the use of custom benchmarks. We believe custom benchmarks are most useful for determining whether a TDF manager is adding alpha through tactical asset allocation and security selection, which are important return drivers but are generally less impactful than strategic asset allocation in determining performance over time.

Innovest: We think about benchmarking from a few different perspectives. First, in our initial selection and in the ongoing monitoring processes, we spend the most amount of time evaluating the glide path. Once the TDF is in place, we feel that any changes to the glide path would warrant putting the TDF on watch as this could be an impactful change from the initial investment. So, first and foremost, the glide path and any potential changes to it, is the most important consideration. We also look at performance versus peers and a custom benchmark. If an investment manager creates a custom benchmark, we utilize that to benchmark performance. Additionally, looking at detailed attribution is important to us. We want to understand where the returns are coming from over time: asset allocation, underlying investments, tactical management, etc., as this will truly provide some insight into how the target date fund has performed over time.

Do you have a select list of target-date-funds you are using today?

USI Consulting Group: Yes, we have a list of target date fund suites that have been identified as representative of meeting a wide variety of plan sponsors objectives. In recent years, we have expanded the list to offer more solutions as plan demographics, participant base, and target date fund suite objectives have evolved. The select list is reviewed holistically on an annual basis following our quantitative and qualitative due diligence

process. From there, we will work from our select list to see what will best fit the plan's investment policy statement objectives. We typically review whether the plan would benefit from a target date fund series that offered more fixed income, equity and/or dividend focus objectives based on statistics such as target income replacement ratio, optimal glidepath aligned with the target income replacement ratio, age of the plan, median savings rate, employee base, participant outcomes, and public benchmark versus investment policy statement objective.

Innovest: We do have a select list of target date funds, which are either funds that plans are currently invested in or funds that our investment team has conviction about as well. We utilize this list as a starting point for choosing the right target date fund for each plan. This list will be reviewed on a quarterly and annual basis to make sure there are no changes in the glide paths or other potential concerns we might have for the Plans invested in the funds.

Chao & Co.: We do not have a select list or a pre set tool to eliminate or pinpoint final target date options. Instead, we have discussions with the Plan Committee on important data points such as fees/expenses, manager tenure, tactical/strategic management, passive/active, at-retirement equity risk allocation, and investment risk/ return range etc. From here, we develop a series of custom screens, using Morningstar Direct, to filter out those TDF series that do not meet the criteria. A final small group of target-date-fund series will filter to the top, and qualitative research would be carried out for each candidate at that point. This will involve discussions with the investment managers to gain an understanding of: (1) what they are trying to solve for, (2) how they elect to express their convictions and (3) what tools and constraints are in place to measure and manage portfolio risks and risk budget.

Are there any interesting tools or processes you use for the Target Date selection and monitoring discussion with plans?

Lockton: Yes, we use two tools for the selection and monitoring of target-date-funds. The first tool provides a deep dive on certain criteria such as asset allocation, glide path, and portfolio composition across the 70+ target-date-fund series in the market today. The second is an interactive online tool that facilitates discussions on plan demographics and helps the Plan select an appropriate target-date-fund. The tool looks at certain criteria for a target

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date fund such as risk preferences by age demographic, “to vs. through,” geographic diversity, glide path, use of alternatives, etc. The importance of every factor can be weighted by the plan. Every TDF series is rated by how well they match up with the specific objectives of the plan sponsor and how well they have performed historically. In this tool, as well as within our monitoring process, we put a heavy focus on risk-adjusted returns as we feel this is critical to determining the success of a target date fund and a more fair basis for comparison.

Innovest: We find the glide path is one of the most critical components to understanding if a target date is the right fit for a plan. So we also believe that monitoring any changes in the glide path is critically important. Therefore, we have developed a specific target date fund questionnaire that we send to TDF managers to update annually. We also prefer to meet with the fund companies directly at least once per year.

Sage View: Yes, we have a number of proprietary tools that assist in the evaluation and monitoring process. We have an online suitability assessment guide that accounts for demographics, plan design, sponsor objectives and risk tolerance to identify TDF glide paths that we believe are potential fits for our clients. We also have a calculator that shows the impact of plan design changes on future retirement income projections, and the implications of these changes on TDF selection. As it relates to performance monitoring, we have a proprietary scoring system that works in tandem with our clients’ investment policy statements and that accounts for numerous factors to quantify how well managers are delivering value on a risk-adjusted basis.

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