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403(b) Plans: What to Know About Target-Date Funds

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The use of Target-Date funds has significantly increased among 403(b) plan sponsors and so have their duties and responsibilities. According to the [403\(b\) Target Date Fund Survey](#) conducted by the Profit Sharing/401(k) Council of America, 50% of respondents now offer Target-Date funds and 20% more are considering adding them sometime in the future. In addition, Target-Date funds are now the most prevalent default fund for automatic deferrals within 403(b) plans.

Given these growth trends we want to keep you informed on recent trends in the Target Date funds (TDFs) marketplace and the hearings conducted in Washington regarding these investment options.

Market Place Trends

Since their 1994 inception, TDFs have continually evolved to meet the changing needs of investors as well as the changing market environment. Enhancements have included modifying glide-paths, increasing diversification and reducing fees/expenses. Over the years, some managers have added new asset classes such as inflation-protected securities, non-U.S. bonds, high yield bonds, emerging markets, commodities and real estate.

One of the most recent innovations within TDFs is the addition of an income producing component such as an annuity type feature which provides a set monthly payment during retirement. While this is a very interesting advancement, it is very early in the evolution process and we expect the marketplace to continue to develop.

Washington Update

Recent hearings have been prompted by the popularity in TDFs and their performance during the recent market downturn. In fact, total assets invested in these funds have grown from \$2 billion in 1997 to \$204 billion in 2008. Much of this growth is due to the Pension Protection Act of 2006 and the subsequent Qualified Default Investment Alternative (QDIA) regulation naming TDFs as an acceptable "default" investment option.

The two main themes of these hearings were whether TDFs have taken on more risk than necessary (i.e. appropriate asset allocation/glide-path) and whether TDFs provide adequate disclosure of the risks inherent in the funds.

Asset Allocation

The marketplace offers a wide range of choice in terms of investment style, philosophy and process. This includes the overall asset allocation decision which is the amount invested in equities and fixed income over the life of TDFs. These varying allocations can expose participants to very different levels of volatility over short periods of time. As an example, two 2030 TDFs could offer vastly different allocations, one being better suited for a more risk averse 2030 retiree (70% equity, 30% fixed income) and one being better suited for a more risk tolerant 2030 retiree (85% equity, 15% fixed income). It's this dispersion that has caught the attention of lawmakers and could result in mandated allocation percentage bands among similar named TDFs if they wish to be considered as a QDIA.

Increased Disclosure

This has been cited as a potential solution for investor misunderstanding of each firm's philosophy regarding the creation and allocation percentage rebalancing of TDFs. One of the most prominent participant misunderstandings is the definition of "target date". The common belief of participants is that assets are managed to the target date, meaning that the asset allocation reaches the most conservative percentage at the retirement date. However, for a majority of TDFs, the assets are actually managed through the retirement date given the assumed 20- to 30-year retirement time period. For example, Fund Manager A might create TDFs with the goal of risk mitigation throughout the life of the investor, while Fund Manager B might create its TDFs with the goal of preventing participants outliving their money. The question remains whether increased disclosure will solve participant misperceptions or are more modifications required such as changing the current naming convention (2010, 2020, 2030...) to more clearly reflect the actual intent of the fund.

It's important to note that no formal policy initiatives, nor any proposed legislation or regulations have yet been proposed. Be assured that we will notify clients should legislation be implemented.

We also recognize that we have only grazed the many concerns circulating around the industry regarding these investment options. In this continually evolving marketplace, 403(b) plan sponsors have a duty to stay informed about changes so please feel free to contact any consultant at DiMeo Schneider & Associates should you have questions or would like to discuss TDFs.