Target Date Funds: Economic, Regulatory And Legal Trends

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December 8, 2017, 10:53 AM EST

Target date funds, or TDFs, are an increasingly important part of the retirement investment universe. These funds are often thought of as holding a mix of debt and equity investments, with the equity proportion declining according to a predetermined glide path. In reality, current TDFs are far more complex. New regulations, such as the U.S. Department of Labor’s Fiduciary Rule, create uncertainties for TDFs going forward. Given these uncertainties and the sheer size of the TDF market, the current docket of TDF-related litigation is likely to grow.

What is a Target Date Fund?

In most cases, a TDF is a fund of funds designed to dynamically allocate across a variety of investment classes based on designated target retirement dates.[1] A TDF’s portfolio composition is set and adjusted by a fund manager primarily based on one key factor: the target date.[2]

Asset Allocation

TDFs are generally designed to take on a more conservative risk posture as the target date is approached or passed. This is because investors who are nearing or are already in retirement are generally viewed as being less willing to bear significant downside risk. Typically, the portion of a portfolio invested in equity is reduced as the target date approaches.[3]

A typical equity investment carries higher financial risk and higher average returns than, for example, a high quality debt security, which contractually requires defined payments and is higher in a company’s capital structure than equity.[4] Table 1 compares the average returns and variability of returns for large capitalization stocks to those of intermediate-term government bonds.

Table 1: Average Monthly Investment Returns and Standard Deviation, 1945 – 2015
Reduction in equity exposure over time, commonly referred to as the “equity glide path,” is generally supported as a risk-reducing mechanism by historical performance statistics of asset classes,[5] but may vary widely between management companies. The targeted equity glide paths of the largest three TDF management companies are compared in Figure 1 below, while Figure 2 depicts the glide paths of a wider range of TDF offerings.

**Figure 1: Glide Paths of Top Three TDF Providers**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Mean Total Return</th>
<th>Standard Deviation of Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Capitalization Stocks</td>
<td>0.97%</td>
<td>4.17%</td>
</tr>
<tr>
<td>Intermediate-Term Government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>0.45%</td>
<td>1.36%</td>
</tr>
</tbody>
</table>

TDF products may also vary widely in the degree of leeway permitted for “tactical allocations” away from listed target allocations.[6] Fund managers may opt to avoid transaction costs associated with perfect rebalancing, but may also deviate from specified targets opportunistically. For example, in a rapidly rising equity market, a TDF with a 90 percent equity target and sufficient tactical leeway might instead shift to 100 percent equity. While studies show that the broader asset allocation decisions determine a large portion of fund return differences,[7] competitive pressures may incentivize TDF managers to chase unwisely more immediate returns.

As shown in Figure 3, the number of investment classes utilized by TDFs has grown well beyond traditional long positions in debt and equity investments, with increasing prevalence of specialized assets such as emerging markets, real estate and commodities, which are utilized to diversify from equity and debt and also as an inflation hedge.[8] However, research suggests “over diversification” may have a negative impact on fund of funds returns.[9]

Figure 3: Prevalence of Various Asset Classes across Glide Paths
Asset architecture presents another layer of variation between TDF products. Managers operating with a “closed architecture” only purchase underlying funds managed by their own fund management company (e.g., a Vanguard TDF might invest only in Vanguard equity and bond funds). Conversely, an “open architecture” approach allocates some investments to funds offered by third-party fund management companies.

These layers of variation result in significant heterogeneity in the risk and return characteristics of different TDFs.[10] During the financial crisis that began in 2007, TDFs with the same target date exhibited striking differences in annual returns. In Table 2, we document the dispersion in TDF returns for several funds with target dates within 15 years of the financial crisis. Funds experienced, to different degrees, large declines in value in 2008 followed by large percentage gains in 2009, resulting in varying four-year annualized returns.

Table 2: Returns of Selected TDFs, 2007 – 2010
Growth Trends and Drivers

TDF assets have seen extraordinary growth over the past decade and currently exceed $1 trillion.[11] The Investment Company Institute reported that as of December 2016, there were $887 billion in TDF mutual fund assets (see Figure 4) and estimated that TDF assets held solely within reported defined contribution plans (including 401(k)s) and IRAs totaled approximately $778 billion, approximately 12 times the level reported at year-end 2005.[12]
A few key drivers have spurred growth in TDFs assets. The first is a shift by employers away from defined benefit plans (e.g., pension plans) to DC plans. By 2005, DB plans were offered by less than half of Fortune 500 companies, and by 2015, under 20 percent.

TDF assets have also grown significantly relative to other investment options. A Plan Sponsor Council of America survey reported that TDF assets comprised approximately 19.8 percent of 401(k) participant assets in 2015,[13] ranking second amongst all fund types, an increase from 12.4 percent in 2011.[14] One research firm has predicted that by the end of 2019, 88 percent of all new 401(k) contributions will be directed into TDFs.[15]

The Pension Protection Act of 2006 served as the most significant catalyst for increasing allocation of investments into TDFs. The qualified default investment alternative, or QDIA,[16] provisions under the PPA 2006 permitted fiduciary liability risk under ERISA to be managed by directing unallocated employee DC contributions into a default alternative or “safe harbor” investment class,[17] and explicitly identified TDFs as such an option.[18] Fund administrators had previously directed most unallocated employee investments into money-market mutual funds or other ultra-safe funds. A significant portion of DC contributions are now automatically directed into TDF funds.[19] According to Vanguard, where plans designated a QDIA in 2015, 95 percent designated a TDF,[20] compared to 80 percent in 2009.[21]

Emerging TDF Fiduciary Issues

Fiduciary Rule under ERISA

The Employee Retirement Income Security Act sets out various standards required of DC plan “fiduciaries,” defined in functional terms of control and authority over the plan. DC plan fiduciaries normally include plan trustees, plan administrators, members of a plan’s investment committee, or anyone who provides investment advice to a plan for compensation.[22]

A fundamental fiduciary duty under ERISA is the duty of “care, skill, prudence, and diligence” that a prudent man would exercise under similar circumstances — sometimes known as the prudent man rule.[23]

Though TDFs are designated as a “safe-harbor” investment type under the PPA 2006, plan administrators continue to have fiduciary responsibilities as to selection of a particular TDF product. Because the investment manager of an externally sourced TDF is generally not a plan fiduciary,[24] DC plan sponsors retain responsibility to evaluate relevant aspects of TDFs in relation to the plan’s goals, considering TDF performance, fees and expenses.[25]

This is demonstrated in Tussey v. ABB Inc.,[26] in which fiduciaries were found to violate ERISA by failing to consider adequately the reasonableness of fees charged by the fund record-keeper.[27] Similarly, in Meiners v. Wells Fargo & Company, the plaintiffs alleged violation of fiduciary duties of loyalty and prudence under ERISA due to their investment “of Plan assets … into Wells Fargo’s own proprietary [TDF] funds,”[28] which are claimed to “cost on average over 2.5 times more than comparable target date funds while …substantially and consistently underperforming those comparable funds.”[29]
In Jacobs v. Verizon Communications Inc., the plaintiffs alleged violation of fiduciary duties in the selection of an employee retirement plan that “added a second layer of investment management fees”[30] by investing into TDFs that included certain “specialty” asset classes in their asset allocation, which “added significant levels of risk and complexity”[31] that made the funds “overly complex, overly risky, and inappropriate for the average Verizon employee.”[32] A similar breach is charged in Sulyma v. Intel Corporation Investment Policy Committee, in which plaintiffs challenged the “prudence” of the fiduciaries’ decision to seek optimal returns while protecting against equity market volatility[33] by investing in more costly actively managed strategies.[34] The plaintiff argued that these “asset allocation models ... departed dramatically from prevailing standards” and presented “unconventional, significant and undue risks and unduly high fees and costs.”[35]

These cases demonstrate potential tension between the “prudence” responsibilities and “diversification” responsibilities imposed on fiduciaries under ERISA. If the prudence standard is interpreted as requiring plan fiduciaries to select TDFs with similar risk, cost, and return characteristics to those selected by most other seemingly prudent plan fiduciaries, this increases the legal and compliance risk of using potentially superior TDF strategies. A TDF designed to avoid downside risk by sacrificing upside or through increased diversification may provide superior “through the cycle” performance while opening DC fiduciaries to criticism for their selection of a high-cost, and therefore “imprudent,” outlier fund.

**DOL’s Fiduciary Rule**

While ERISA applies fiduciary standards to any party with control or authority over an employer sponsored retirement plan,[36] the DOL’s fiduciary rule effectively applies a fiduciary standard to registered representatives who provide recommendations on non-ERISA retirement investment accounts, such as IRAs.

Broadly, the fiduciary rule moves broker-dealers and affiliated RRs from the less strict “suitability” standard to a fiduciary “best interest” standard, with respect to their investment recommendations on non-ERISA retirement accounts. An example of a previously acceptable TDF recommendation potentially failing the new best interest standard would be the purchase of a generally suitable TDF over a virtually identical, but less expensive, alternative.[37]

Analyses of value versus cost of a TDF may be complex and multifaceted, however. If a more expensive investment option provides relatively poor performance, this does not imply that it was a suboptimal choice. The selection process and periodic reassessment are critically important, given that future returns are unknowable. Important features such as investment manager experience, risk management systems and hedging strategies may only demonstrate their benefits during time periods exhibiting turbulent markets, for example.

Initial reports indicate that the new fiduciary rule has led to reductions in brokerage account types in which customers are charged on transactions and where brokers are typically compensated through sales commissions — leading to potential conflicts of interest. Conversely, non-commission accounts such as fee-based accounts and self-directed brokerage accounts have increased.[38]

The DOL’s fiduciary rule has the potential to result in a significant number of lawsuits under the new private right of action for investors. Given that wide variation will lead to significant performance differences across TDFs, purchase recommendations for a specific TDF investment may give rise to
lawsuits if the TDF realizes lower returns than other options. Brokerage firms should therefore mitigate their legal risk by maintaining documentation as to why a particular TDF was viewed at the time to be in the best interest of the client.

Given the long-term nature of TDFs and potential litigation that may be sparked by the fiduciary rule, the quantification and valuation of proper risk management, experience and other less tangible factors is likely to become an increasingly important area of expertise for fiduciaries and experts.

**Conclusion**

The size, heterogeneity and complexity of the TDF market have clearly increased over recent years. This backdrop along with the evolving regulatory frameworks and legal decisions make TDFs an important area to monitor going forward.

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[1] Some TDFs are designed to be used for 529 Plan education savings programs, and thus their target dates aren’t retirement-based.

[2] As with any U.S. open-end mutual fund, objectives and constraints of the fund are described in the offering documents.

[3] Some TDFs only adjust fund allocations up “to the target date,” while others adjust allocations “through the target date.”

[4] In terms of corporate capital structure, bond payments have priority over equity.

[5] Despite the baseline points, it should be clear that not every portfolio with less equity should be considered less risky than one with more equity and vice versa.

[6] See, e.g., Dynamic Target Date Funds Prospectus for Class R6, Wells Fargo Asset Management, October 1, 2016, p. 22, accessed May 23, 2017, https://www.wellsfargofunds.com/assets/edocs/regulatory/prospectus/dynamic-target-date-r6-pro.pdf. (“At their discretion, the Fund’s portfolio managers may make changes to the Fund’s asset allocation. At any point, as a result of the utilization of the futures overlay and changes otherwise implemented by the portfolio managers, there may be significant divergences between the effective asset allocation of the Fund and its strategic target allocation.”)


See 29 CFR § 2550.404c-5 (“Fiduciary relief for investments in qualified default investment alternatives”).


Ibid.


See, e.g., “Fiduciary Responsibilities,” U.S. Department of Labor, accessed May 23, 2017, at https://www.dol.gov/general/topic/retirement/fiduciaryresp. (Fiduciary duties are owed under ERISA by “persons or entities who exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so are subject to fiduciary responsibilities” including “plan trustees, plan administrators, and members of a plan’s investment committee.”)


See U.S. Department of Labor, Employee Benefits Security Administration, Advisory Opinion 2009-
and-advisers/guidance/advisory-opinions/2009-04a; see also “Fiduciary Guidebook for Target Date 

[25] “Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries,” U.S. Department of Labor, 
Employee Benefits Security Administration, February 2013, p. 2, accessed May 23, 2017, 
https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-
sheets/fsTDF.pdf.


[27] Id. at 341.

2017) (No. 16-cv-03981).

[29] Id. at ¶ 3.


[31] Id. at ¶¶ 17-18.

[32] Id. at ¶ 9.


[34] Ibid.


Commission, March 11, 2011, accessed July 17, 2017, 

[37] Carmen Germaine, “SEC Muddies Fiduciary Rule Waters With Comment Request,” Law360, June 7, 
fiduciary-rule-waters-with-comment-request.

[38] Lisa Beilfuss, “Fiduciary’ Rule Accelerates Account Shift Across Brokerage Industry,” The Wall Street 
account-shift-across-brokerage-industry-1500494055.