Alternatives to Using Target Date Funds as QDIAs

A Practical Guidance® Practice Note by Carol I. Buckmann, Cohen and Buckmann, P.C. with Lyle B. Himebaugh III, Granite Group Advisors

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This practice note discusses the alternatives to use of target date funds (TDF) as a qualified default investment alternative (QDIA) in an individual account plan (defined contribution plan) that is subject to the rules of the Employee Retirement Income Security Act (ERISA). Final regulations issued in 2007 describe mechanisms for investing participant accounts, ensuring that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a participant's long-term retirement savings needs.

The final regulation sets forth four types of QDIAs:

- **Target date funds.** A product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life cycle or targeted-retirement-date fund).
- **Managed account.** An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally managed account).
- **Balanced fund.** A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund).
- **Short-term fund.** A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt out of participation before incurring an additional tax). While many plan fiduciaries were using capital preservation products as default investments prior to these rules, the Department of Labor (DOL) determined that they were not appropriate as a long-term safe harbor default investment.

72 Fed. Reg. 60,452 (Oct. 24, 2007) (the QDIA Regulation). A QDIA must either be managed by an investment manager, plan trustee, plan sponsor, or a committee comprised primarily of employees of the plan sponsor that is a named fiduciary or be an investment company registered under the Investment Company Act of 1940. Also, a QDIA generally may not invest participant or employer contributions in employer securities, except that employer matching contributions invested in employer securities that are part of a managed account may be part of a QDIA if they are managed by the managed account's manager. 29 C.F.R. § 2550.404c-5(e)(1).

This practice note will discuss the alternatives to use of traditional target date funds (i.e., the first category, above) as QDIAs and why fiduciaries may want to consider them. The primary topics discussed will be:

- QDIA Background
- Why Consider Alternatives to Target Date Funds?

- Evaluating Balanced Funds as a QDIA
- Evaluating Managed Accounts
- Good Fiduciary Practices Include Regular Evaluation of the QDIA Choice

For related content, see Target Date Fund Considerations for Plan Fiduciaries, ERISA § 404(c) and QDIA Safe Harbors, and QDIA Checklist. For a discussion on QDIAs with a focus on a target date fund's glide path, see ALI-ABA Course of Study Materials, "Target Date Funds" (SR020 ALI-ABA 607) and DOL, Advisory Council Report on Hard to Value Assets and Target Date Funds.

QDIA Background

With the increasing popularity of plan auto-enrollment features, significant numbers of plan participants are brought into defined contribution plans without any affirmative action on their part. Even more may have their accounts invested automatically because of automatic re-enrollment, which is the practice of requiring participants to make new investment elections (invalidating their old ones) if they do not respond by a deadline. Significant numbers of these participants fail to complete personal investment elections, which means that plan fiduciaries must select investments for them. This leaves the fiduciaries open to potential exposure if their choices result in investment losses in the accounts of the participants who have not made their own elections.

QDIA's are fiduciary safe harbor default investment choices established by the DOL. Fiduciaries who prudently select default investments for plan participants who do not or cannot select their own investments are generally not responsible for investment losses incurred by these participants if the fiduciaries direct their investment into a QDIA. While a QDIA is a safe harbor default investment, in an Information Letter issued to Christopher Spence of TIAA in 2016, the DOL indicated that an investment alternative that did not satisfy all of the QDIA regulatory requirements set forth in 29 C.F.R. § 2550.404c-5, could nevertheless be a prudent default investment. DOL, Information Letter 2016-12-22.

Target date funds have been the overwhelmingly popular QDIA choice for plan fiduciaries, although they are very complicated and have pros and cons. Although they may be an appropriate QDIA choice, all too many plan fiduciaries fail to realize that target date funds are not the only permissible QDIA safe harbor choice and select these as the plan's QDIA without considering the other options under the DOL regulations. In addition, fiduciaries may not be aware that there are now hybrid arrangements available in the market that combine target date funds with managed accounts. In the preamble to the QDIA Regulation, the DOL indicated that fiduciaries were not required to evaluate all three long-term QDIA options before making a QDIA selection, as all three had been deemed appropriate choices. 72 Fed. Reg. 60,467. Nevertheless, such evaluations may be part of a prudent selection process that will help the fiduciaries prevail in litigation challenging the plan's investment menu or QDIA investment. See Why Consider Alternatives to Target Date Funds? below for recent QDIA litigation.

Department of Labor Guidance

The DOL does not produce a list of approved QDIA funds. Rather, in the QDIA Regulation, the DOL has designated three types of funds as appropriate QDIAs for other than short-term investment: (1) target date funds (sometimes called life cycle funds), which change the mix of equity and fixed income to become more conservative over time as the participant nears an assumed retirement age; (2) balanced funds; and (3) managed accounts.

QDIA Requirements

A fiduciary selecting one of these types of funds must provide required disclosures to participants and beneficiaries regarding the QDIA to take advantage of the safe harbor. These are:

- An annual disclosure (notice) of the circumstances under which accounts will be invested in the QDIA
- A description of the chosen QDIA's fund's objectives, risk and return characteristics, and fees
- An indication of participants' and beneficiaries' right to direct investments and to direct their investments into funds other than the QDIA
- A description of any restrictions, fees, or expenses imposed in connection with a transfer out of the QDIA by participants and beneficiaries –and–
- All of these requirements must be satisfied in order for the safe harbor protection to be available

See 29 C.F.R. § 2550.404c-5(d)(1) through (4). These requirements are described more thoroughly in ERISA § 404(c) and QDIA Safe Harbors, QDIA Checklist, and Target Date Fund Considerations for Plan Fiduciaries.

It is worth noting that ERISA preempts any state law that would otherwise restrict employee contributions under an automatic contribution arrangement (i.e., law that would prohibit deducting contributions from their compensation without their consent) if the plan also has a QDIA as a default investment. 29 C.F.R. § 2550.404c-5(f).

A QDIA need not be a mutual fund or a separate security. The QDIA Regulations make clear that model portfolios, and investments through common or collective trusts and variable annuities, may qualify as QDIAs. See 29 C.F.R. 2550.404c-5(e)(4)(vi). Even a robo-adviser, which is an automated service that uses an algorithm to allocate assets among the plan's investment menu choices in accordance with investor information, and which is considered to be an investment adviser by the SEC, may be structured to satisfy the QDIA requirements. See SEC Advisers Act Rule 203A-2(e), which permits "internet only advisers" to register with the SEC. 17 C.F.R. § 275.203A-2(e). As registered investment advisers, they are eligible to be investment managers as defined in Section 3(38) of ERISA. 29 U.S.C. § 1002(38).

The DOL has proposed to increase the amount of information required in these QDIA disclosures, including a requirement that any target date fund describe its glide path and how the investment allocation in a target date fund changes over time. To date the proposed regulations have not been finalized. See 75 Fed. Reg. 73,987 (Nov. 30, 2010).

Limits of QDIA Safe Harbor Relief

It is important for fiduciaries to understand that it is the DOL's position that the safe harbor does not exempt fiduciaries from the obligation to prudently select and monitor the QDIA or the requirement that investment fees must be reasonable. See 29 C.F.R. § 2550.404c-5(b)(2). Fiduciaries also remain responsible for avoiding prohibited transactions in their selection, which may become an issue if proprietary target date funds are selected for plans covering employees in the financial services industry. 29 C.F.R. § 2550.404c-5(b)(3).

Accordingly, a fiduciary who selects a QDIA may still be sued by participants or challenged by the DOL on the grounds that:

- The QDIA is underperforming and/or has high fees –or–
- If it is a proprietary fund, the sponsor has (allegedly) received fees from an inappropriate investment, such as a new fund that does not have a proven track record

While not legally required, it is best practice for the plan fiduciaries to have a documented process for determining and evaluating QDIAs incorporated in the plan's investment policy statement (IPS). This is important not only as a potential litigation defense, but in demonstrating how fiduciary responsibilities in connection with the selection and monitoring of the QDIA were satisfied if that information is requested in a DOL audit or inquiry. For a sample investment policy statement, see Investment Policy Statement (Defined Contribution Plan) and Investment Committee Issues for Defined Contribution Plans — The Investment Policy Statement (IPS).

QDIAs must also be appropriate for the group of participants in the plan. The DOL has favorably commented on the use of custom target date funds tailored to the characteristics and risk tolerances of a plan's participants as an alternative to prepackaged target date funds.

Limitations, including Consideration of Environmental, Social, or Governance Factors

As a general matter, a QDIA may not invest participant contributions in employer securities. 29 C.F.R. § 2550.404c-5(e)(1)(i). In addition, under DOL proposed regulations, a fund that applies environmental, social, or governance factors, called an ESG Fund, or a model portfolio using an ESG-themed fund as a component, may not be a QDIA. See Prop. Reg. 29 C.F.R. § 2550.404a-1(c); 85 Fed. Reg. 39,113 (June 30, 2020). In the preamble to the proposed regulations, the DOL indicates that the reasons for this position are:

- It is not appropriate to put participants into these funds absent their affirmative election –and–
- A fiduciary selecting an ESG default investment based on the fiduciary's personal preferences may be violating the fiduciary duty of loyalty

85 Fed. Reg. 30,119. It is not certain that final regulations will contain this ESG restriction, as there were many comments filed that criticize the approach taken in these proposed regulations during the public comment period ended on July 30, 2020.

Why Consider Alternatives to Target Date Funds?

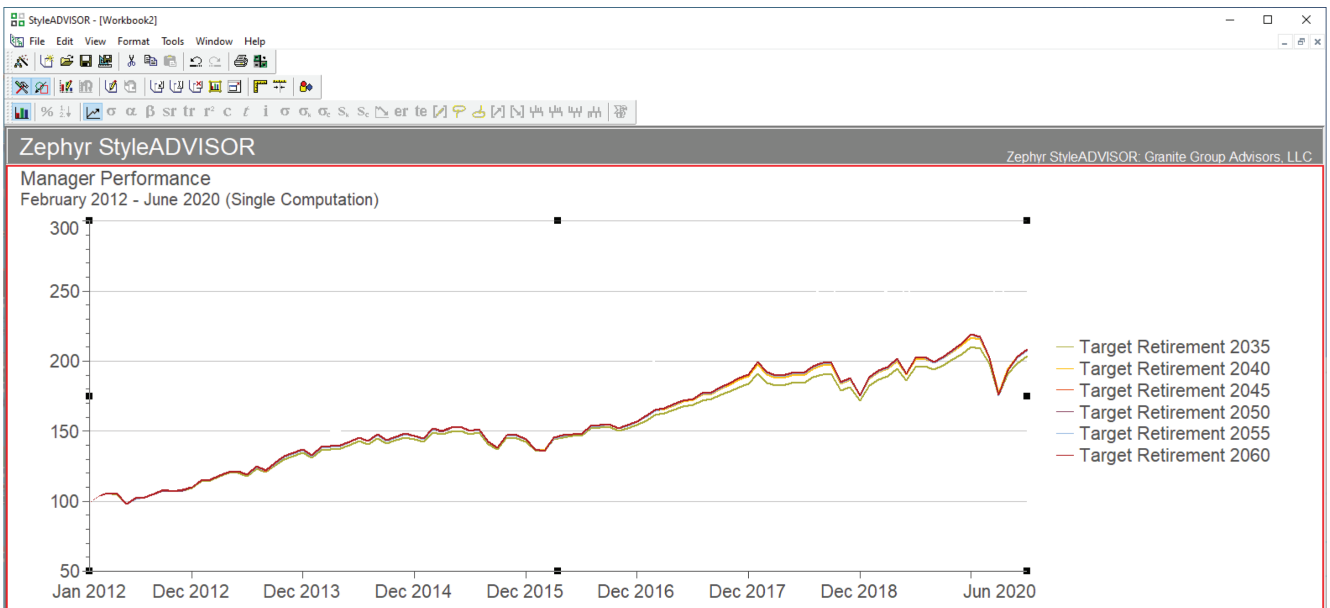
Despite the popular choice of target date funds as QDIAs, these funds did not perform well in the recession of 2008 and, even in March 2020, incurred losses at the start of the coronavirus pandemic that led a significant percentage of participants nearing retirement age to realize those losses in order to pull out of the funds. Funds have rebounded, but if COVID-19 triggers a prolonged recession, that situation may change.

Glide Paths and Fees

Target date funds are not fungible, and, in addition to varying by fees and performance, target date funds have different management styles (passive, active, or a combination), different investment allocations, and levels of investment in alternative investments. They also have different glide paths (i.e., the proportion of fixed income and equity at different ages is not uniform across funds), and will differ in their equity exposure at and after the fund's assumed retirement age even for identical target retirement ages. See pp. 94–129 of SEC and DOL Public Hearing on Target Date Funds and Other Similar Investment Options, June 18, 2009, and BUSINESS ARTICLE: TARGET DATE FUNDS: CAN ONE JUST GLIDE INTO RETIREMENT?, 10 J. Int'l Bus. & L. 349.

It is important for fiduciaries to understand that target date funds have multiple layers of fees because they are commonly an amalgamation of underlying funds selected by the fund manager, and those underlying funds will have their own fees. The funds that have the lowest fees will use index funds as their underlying investments.

Target date funds are difficult for plan fiduciaries to understand and review, even with assistance of an investment advisor. They are even more difficult for participants to understand. A recent survey by Alight found that 59% of participants surveyed said that they didn't know anything about target date funds. They have a "one size fits all" investment philosophy that makes the same investments for all participants with the same assumed retirement age regardless of their outside assets and personal risk tolerances. See, e.g., WealthManagement.com, COVID-19 Infects TDFs. As an example, the same aged CEO and staff personnel would be in the same investments even though there are probably two different personal finance scenarios. Additionally, because traditional target date funds do not materially vary their allocations until the 10 years preceding the assumed retirement age, there is little variance in performance between, say a Target Retirement 2040 Fund and a Target Retirement 2060 Fund. That would also mean that a 25-year-old and a 50-year-old participant would have close to the same returns over the past several years, as revealed in the chart below.



Custom Table
February 2012 - June 2020: Summary Statistics

	Return	Cumulative Return
Target Retirement 2035	8.80%	103.38%
Target Retirement 2040	9.10%	108.08%
Target Retirement 2045	9.11%	108.33%
Target Retirement 2050	9.11%	108.38%
Target Retirement 2055	9.09%	108.06%
Target Retirement 2060	9.12%	108.43%

Performance | Mgr vs BM | Calendar Returns | Style Graphs | Risk Return | Up Down | Multi Statistic | Mgr vs BM Multi Stat | Histogram | Ex Returns / Tracking Error | Batting Average | Drawdowns | Mgr vs Univ Bars | Mgr vs Univ Rank | Mgr vs Univ Multi Stat

*Analytics supplied by Zephyr. The authors of this practice note are not responsible for the data.

Recent Lawsuits

401(k) plan litigation challenging plan investments as imprudent is finally reaching target date funds. There is increasing litigation over target date funds by participants claiming that the funds were imprudent investment choices.

A major lawsuit challenging Walgreens' selection of target date funds for its plans, Brown-Davis v. Walgreen Co., was filed last year, claiming that the plan lost $300 million due to the selection and retention of underperforming target date funds for over 10 years. The lawsuit survived a motion to dismiss, but the judge ruled that plaintiffs had standing only to challenge funds in which they had invested. (No. 1:19cv-053921, N.D. Ill., March 26, 2020).

Since the advent of the coronavirus pandemic, there have been additional lawsuits filed against Estee Lauder, Quest Diagnostics, and Eversource Energy (Northeast Utilities), with claims for damages and equitable relief based on detailed demonstrations of how more appropriate target date fund choices were available. The cases are Bilello v. Estee Lauder Inc. (S.D.N.Y., filed June 23, 2020), House Johnson v. Quest Diagnostics (No. 2:28cv-07936, D. N.J., filed June 29, 2020), and Garthwait v. Eversource Energy Service Company (D. Conn., filed June 30, 2020). Each of these complaints recites that plaintiffs' benefits were determined by the market value of these funds. The *Estee Lauder* case names the board of directors as a defendant based on its duty to monitor the performance of the investment committees it appointed. There has not been a higher court decision definitively setting forth the standards and process fiduciaries should use to review their target date fund selection. Accordingly, fiduciaries are at risk if they do not understand how these funds operate.

There has been a herd mentality leading some advisers to recommend target date funds without discussing with plan sponsors or fiduciaries the alternative QDIAs that are available or the hidden risks in target date funds. For example, recent litigation against U.S. Bank and Fujitsu Technology has put a spotlight on target date funds that invested in nontraditional investments. In *Johnson v. Fujitsu Technology and Business of America Inc.*, plaintiffs alleged that inexperienced advisers were hired to construct custom target date funds that included natural resource and real estate partnership investments. Johnson v. Fujitsu Tech. & Bus. of Am., Inc., 250 F. Supp. 3d 460 (N.D. Cal. 2017). A recent Information Letter issued to the Groom law firm may increase this under-the-radar risk, as it confirmed that private equity may be an appropriate investment for some of a target date fund's assets. DOL, Information Letter 2020-06-03 issued to Jon W. Breyfogle.

All too often, company fiduciaries simply pick their vendor's target date funds as QDIAs because it is convenient, their outside advisor, who may or may not be a fiduciary, recommends them, or they are recommended by their vendor's employees when the plan is being set up. Vendor employees are not usually acting as fiduciaries under current law when they make these recommendations, and in some circumstances selecting these funds without considering the alternatives may be a breach of fiduciary responsibility.

Evaluating Balanced Funds as a QDIA

Balanced funds are typically invested in a fixed proportion of equity and fixed income (typically 50%–70% of investments in stock) that does not change over time or vary by participant. While balanced funds have fallen out of favor and their use has declined with the advent of target date funds, they may be appropriate for particular participant groups who seek more diversification (than TDFs typically offer). If they are, they will not have the layers of fees typical of target date funds. They also are easier to understand and explain to participants.

The DOL defines a balanced fund as a fund product or model portfolio that applies generally accepted investment theories, is diversified, and is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income investments with a target level of risk appropriate for participants in the plan as a whole. A balanced fund is not required to take into account an individual participant's age, preferences, or risk tolerance. 29 C.F.R. § 2550.404c-5(e)(4)(ii).

In the preamble to the Final Regulation, at 72 Fed. Reg. 60452, the DOL provides additional information about its view of when a balanced fund may be an appropriate QDIA. Fiduciaries should look at the appropriateness of the asset mix for a particular group of participants. Some questions may be:

- Are participants in a fairly uniform age group, or are they spread out across a broad range of age groups?
- Does this group have high or low turnover?

Consider that participants may have different risk tolerances. The DOL states in the preamble to the regulation that in considering whether to adopt a balanced fund as a QDIA, fiduciaries should take the same considerations into account as they would when managing a plan without participant-directed investments. 72 Fed. Reg. 60,461. The application of this rule means that the more stable the group and the more limited the age range of the plan participants, the more appropriate this more simplified QDIA may be, *provided* that the asset mix is appropriate for the group and the fees are reasonable.

Advantages and Disadvantages of a Balanced Fund Compared with a TDF

An advantage of selecting a balanced fund as a QDIA, provided that it is appropriate for the participant group, is that many of these funds have been in existence a long time and have proven track records and a lengthy performance history. They are much less likely to have unappreciated risk and nontraditional investments. However, compared to target date funds, balanced funds will not provide the ability to select investments that become more conservative as the participant gets closer to retirement age. Since they are not a fund of funds, they are also not subject to the types of conflicts that arise when a target date fund is constructed of funds within the same fund family. They do provide diversification between stock and bonds within the fund as opposed to longer dated target date funds that lean on stocks for the majority of the allocation. As an example, a balanced fund might have a mix of stocks and bonds. They could range from 60% stocks / 40% bonds or another combination, depending on the investment fiduciary's determination. A 2040-2065 target date fund, depending on the fund family, will mostly likely have a 90%+ exposure to stocks.

Choosing a balanced fund does not necessarily mean that potential returns are sacrificed. According to some experts, balanced funds may always be a more appropriate choice than a target date fund. According to the Brookings Institution, balanced funds are likely to have higher net returns than target date funds over the long term because no one can predict exactly when equities will outperform bonds. A 2019 article cites research by the advisory firm Research Associates showing that over time, target date funds deliver smaller returns and larger losses than a 50/50 balanced fund. Marketwatch, (Feb. 20, 2019).

Evaluating a Managed Balanced Fund vs. a Balanced Fund

In advising plan fiduciaries, you may want to counsel them to consider a managed balanced fund. A managed balanced fund is a hybrid that has the same benefits of a balanced fund, plus the advantage of having an investment fiduciary (a Section 3(38) investment manager) select individual independent mutual funds for the total portfolio. When a Section 3(38) manager oversees a managed balanced fund, there usually are no proprietary funds within the portfolio that would limit conflicts of interests.

In a managed balanced fund, the investment fiduciary should have a documented investment process on how it selects and terminates the manager(s) for the independent funds. This approach, overusing a balanced fund alone, should provide consistency and smoother returns for the participant.

And, by having a managed balanced fund as the plan's QDIA, a defaulted participant potentially could have higher returns as the portfolio is being professionally managed (i.e., the investment manager will be proactive). In addition, the managed balanced fund would have additional investment fiduciary oversight since it is managed in accordance with the Section 3(38) investment fiduciary's responsibilities.

Fees

If the Section 3(38) investment fiduciary to the plan offers a managed balanced fund as a plan's QDIA, it should be at no extra charge to the plan, or plan participants, as fiduciaries cannot double charge to be the advisor to the plan and to the portfolio. In fact, there shouldn't be an increase in overall fees if the balanced fund structure is managed correctly.

Evaluating Managed Accounts

Managed accounts are gaining in popularity as alternatives to target date funds as QDIAs, either separately or as hybrids in combination with traditional target date funds. These are accounts that must be managed by a professional investment manager as defined in Section 3(38) of ERISA. This management relieves the plan fiduciaries of responsibility for the day-to-day investment decisions made by the investment manager. Of course, it does not relieve the fiduciaries of their ERISA responsibilities for prudently selecting the investment manager, including their prudent selection of the bank, insurance company, or investment adviser who satisfies the requirements of an investment manager. Nor does it relieve the plan sponsor, acting directly or through a committee comprised primarily of employees, that is a named fiduciary (for investments) within the meaning of Section 402(a)(2) of ERISA. 29 U.S.C. § 1102(a)(2). For a discussion of hiring and maintaining an investment manager, see ERISA Fiduciary Compliance for Investment Managers and Investment Manager Hiring Considerations for ERISA Pension Plans.

The DOL defines this third alternative for a long-term QDIA, as "an investment management service with respect to which a fiduciary . . . applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy." See 29 C.F.R. § 2550.404c-4(iii). Managed accounts are given as an example. Such accounts might be designed for aggressive, moderate, and conservative risk groups. Managers of managed accounts, in choosing the plan investments, are not required to, but may, take into account the risk tolerances or preferences of individual participants.

Modeling Managed Accounts

There are several different types of managed account models. Some maintain a static allocation to bonds, stocks, and cash; and some are more tactically managed.

Many managed accounts are structured to be asset allocation services with model portfolios. A managed account may be a fund of funds and is not required to have individual direct investments. However, in order to satisfy the QDIA requirements, a managed account must not include any investments that are not available to participants who are not in the service. A managed account intended to serve as a QDIA will use personal information obtained from participant questionnaires. The manager may obtain information about participants who do not complete questionnaires from the plan recordkeeper or from the plan sponsors human resources systems. If a managed account is an asset allocation service rather than a unitized investment and does not include investments not on the regular fund menu, it is not required to be treated as a "designated investment alternative" for purposes of annual participant investment and fee disclosures required by 29 C.F.R. § 2550.404a. See DOL Field Assistance Bulletin 2012-02R, Q&A 28.

In the preamble to the Final Regulation, the DOL indicates that a fiduciary using an investment management service as its QDIA under the managed account option must evaluate and prudently select among the different investment management services. 72 Fed. Reg. 60,453. Evaluating a service is slightly different than evaluating an investment fund, though some of the same factors, such as fees, and whether management is active, passive, or a combination of both, remain the same. Among the special factors to be considered are how the plan's investment options are used within the managed account, the number of asset classes, making sure that the manager does not use investments not in the plan's general investment menu (which would prevent the managed account from qualifying as a QDIA), how to benchmark the managed fund, whether the manager gradually moves the participant into the recommended portfolio allocation or moves into it immediately, how often the manager reviews the allocations, whether target date funds and balanced funds are used within the managed account portfolio, and the quality of call center support for participants.

In comparison with target date funds, managed accounts:

- Can be managed to respond more quickly to changing market conditions
- Can be managed to take into account individual risk tolerances and financial needs of different participants to a greater extent than other options
- Do not lock participants into risk profiles they may not want
    - We hear anecdotally that participants sometimes lie about their ages because they are not happy with the investment mix and risk level assigned to them based on their age under target date funds.
- May have higher fees, though according to Cammack Retirement, the fees are typically much lower than those for a managed account not part of a retirement plan

See Cammack Retirement, "Custom QDIAs: Is Now the Time?" (May 27, 2020). A growing trend is the combination of target date funds and managed accounts. Participants can be moved into managed accounts for more personalized investments as they near retirement age under this hybrid QDIA option. While participants will have the right to opt out of the managed account feature, some practitioners have expressed concern about the appropriateness of this option for participants who are in the default investment to begin with because they are passive and resist taking affirmative action with respect to their accounts. Their concern is that the fees for the managed account may be higher than those for the target date fund in which the participant was previously invested.

Good Fiduciary Practices Include Regular Evaluation of the QDIA Choice

In the preamble to the QDIA Regulation, the DOL states that it is not requiring plan fiduciaries to evaluate all three QDIA alternatives before making a decision. 72 Fed. Reg. 60,467. But in light of the amount of litigation challenging plan investment choices, investigating the alternatives would be a protective step and clearly a prudent practice. Company fiduciaries who do not have the expertise to do such an evaluation should hire expert advisers to assist them and should document in writing the process they followed in selecting an appropriate QDIA. Since the options and products available in the market are always changing, periodic requests for proposals (RFPs) and benchmarking are also recommended.

For a checklist that you can use in organizing an RFP, see Service Provider Request for Proposal Checklist (Qualified Retirement Plan).

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