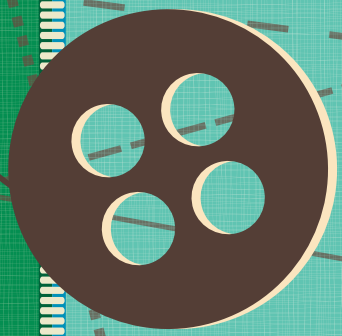
FEATURE

Custom 'Fit'?



Is the time ripe for a move to custom target-date funds?

BY JUDY WARD

As target date fund assets swell, a growing number of large plans have moved to custom TDFs. Sponsors shouldn't assume they ought to follow, however.

"One thing we've seen out there is this assumption that custom target funds are just better than off-the-shelf target date funds," says Scott Cameron, chief investment officer and a principal at advisory firm Multnomah Group, Inc. in Portland, Ore. "There is a mindset that it makes sense to take the expertise on the defined benefit side and apply it to target date funds."

The U.S. Department of Labor's February 2013 tips for fiduciaries on target date funds suggested that sponsors consider using custom TDFs, and Multnomah Group helps sponsor clients periodically evaluate a potential move to custom funds. But it tends to be pretty cautious as to whether custom makes sense, Cameron says, due to the fees and heightened sponsor responsibility involved.

And a lawsuit filed against Intel Corp. in October 2015 (see "Cases in Point," page 50) raises questions about sponsors' decisions on custom funds. *Sulyma vs. Intel Corporation Investment Policy Committee et al* alleges that the Intel 401(k) plan's DB-like custom target date funds have large allocations to risky, high-cost investments that diverge from industry standards for TDF portfolios. However that case gets resolved, "This says, 'You are not immune from doing your due diligence on these products, just because they are custom funds,'" Cameron says. "You still have to make sure that they make sense for your participants."

Advisor Steven Glasgow also helps sponsors consider custom TDFs periodically, but he remains skeptical. "Is the headache and risk worth it for sponsors? I'm still not convinced that there is so much value to be added through the customization of these products," says Glasgow, senior vice president at Avondale Partners, LLC in Nashville, Tenn. "The DOL memo says sponsors ought to consider custom funds. My take is that it is a conversation worth having, but I am not sure that it is a clarion call that everybody should be going that way."

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Key Areas to Consider

Many large 401(k) plans already have moved to custom target date funds. As a 3(38) fiduciary, AllianceBernstein L.P. (AB) manages $34 billion of custom TDF assets, mostly for plans with $1 billion or more in total assets, says Dick Davies, senior managing director at AB in New York. "Clearly, in the mega-plan space, it is well-accepted," he says. "We could even debate if it's relatively mature." AB's custom TDF clients have anywhere from $10 billion in target date assets to less than $100 million.

There's sometimes a misconception that sponsors who have switched to custom TDFs made the change because of very unique participant demographics, Davies says. "Our experience is that custom is much more about open architecture," he says.

"The sponsors who do it believe in some level of active management, and they also have preferences on investment managers in different asset classes. They want their target date funds to be open architecture, just as their core menu has become open architecture." They also want to mix use of active and passive management in ways that institutional investors often do, but off-the-shelf TDFs typically don't, he adds.

All of AB's custom clients use TDFs as their plan's default investment, and 50% to 70% of plan assets may be in those funds. "If that's the case, do you really believe that a single-manager solution is going to be both a good fiduciary decision and a good investment decision?" Davies asks. As target date assets increase and 401(k) plan sponsors get more comfortable with custom-fund elements such as collective trusts, he says, "I think we will see greater acceptance of institutional solutions in general."

Advisory firm Portfolio Evaluations, Inc. (PEI) has incorporated a periodic custom funds discussion with sponsors into its TDF evaluation process, says Ashley diMayorca, senior consultant at PEI in Warren, N.J. "In every case, the plan sponsor has decided in the end not to go down that path," she says. "It's interesting, there is so much noise out there on custom target date funds. There is a lot of talk about custom, but really not a lot of movement."

Advisor Jason Chepenik has spoken more about custom TDFs recently with potential sponsor clients whose plans already have succeeded in helping raise participants' savings rates. "Now they are asking, 'What is the next thing we can do to add color and depth to the plan?'" says Chepenik, managing partner at Chepenik Financial in Winter Park, Fla. "It takes time. But I do see it moving that way."

Sources suggest weighing the pros and cons in these key areas:

Assets Needed and Actual Customization Level

Plans have barriers to entry in moving to custom TDFs, says advisor Dan Peluse, director of retirement plan services at Chicago-based Wintrust Wealth Management. With a minimum of $20 million to $25 million in assets — total plan assets or TDF assets specifically, depending on the investment manager — a sponsor has some ability to choose the underlying funds used, he says. "The investment manager will say, 'Here is our glide path, and you can utilize your core funds to make up that allocation,'" he explains. "Then the sponsor will get a more off-the-shelf asset allocation, not a customized glide path for its employees. It is not until a plan gets to $50 million and north in assets that it can get a glide path that is more customized."

Some advisory firms currently promoting their ability to serve as 3(38) fiduciaries and design custom target date funds do not put a lot of substance behind that, Glasgow believes. "People need to get nitpicky about this terminology," he says. "We have some

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competitors who are now, all of a sudden, in the asset-management space. They say they can create 'custom' target date funds, but the glide path might be uniform across all clients. I don't view that as true customization. A true custom target date fund is when the client makes the decision first and foremost with respect to the glide path, then asset allocations get made in line with that."

Fee Implications

Custom TDFs make the most sense fee-wise for large employers that have a defined benefit plan with investments they also can leverage in the 401(k)'s custom funds, lowering investment fees for both plans, PEI finds. Otherwise, says diMayorca, citing several additional costs beyond investments, "It is around four to 10 basis points for the glide path design, and 25 to 50 basis points for custody, including striking the daily net asset value. And one thing some people don't consider is the cost of custom participant communications for custom funds."

Advisor Robert Lawton says he cannot see how implementing custom target date funds doesn't result in higher advisory fees. "Number one, you have to do a demographic study that shows participants' projected retirements are different from what other, off-the-shelf TDF series are assuming. You have to come up with data to justify using custom funds," says Lawton, founder and president of Milwaukee-based Lawton Retirement Plan Consultants, LLC. "And then putting together a custom benchmark, back-testing it, and maintaining it costs money. Each reporting period, there will need to be a custom set of reports based on that synthetic benchmark."

As for investment fees, Peluse sees sponsors making more of a move to passive off-the-shelf TDFs, which often carry fees comparable to or lower than custom funds. "It is hard to find a justification, from a cost perspective, to go custom versus use index funds," he says. "And it's unknown: For the cost of custom funds, are you creating enough benefit for participants?"

Participant Demographics

Sponsors interested in custom funds need to consider the demographic justification carefully. "It's deeper than just looking at, 'What industry are you in, and how much money are employees making?'" Chepenik says.

As PEI first started doing custom TDF analysis for clients, it asked four large custom TDF providers about which participant variables influence glide path design most. "They said the biggest impacts come from retirement age and what participants do with their assets: Do they leave the money in the plan or roll it into an IRA?" diMayorca says. "Company stock is another big factor. How many participants have company stock in their account, and how much do they have invested in company stock?"

Custom funds often make more sense for employers that have an additional retirement plan such as an active pension plan, Peluse says. Beyond that, he adds, "Very rarely do you find a demographic that is skewed outside the norm to the point that it makes sense to customize a glide path."

Asked whether the wide range of off-the-shelf TDFs available give sponsors enough to pick from for almost any plan's demographics, Glasgow says, "Oh yes, absolutely. There is plenty there to address the demographics question."

Fiduciary Risk

Concern about the potential for future participant lawsuits has played a part in Glasgow's sponsor clients deciding not to go the custom route. "The general consensus is that once a sponsor assumes responsibility for a glide path it created, the sponsor may find itself in a position in the future to defend the glide path that it created," he says. "If you're the author of the glide path and it doesn't work out, if puts you at greater risk."

Much of the previous interest in custom TDFs stemmed from sponsors wanting to move away from proprietary underlying funds within off-the-shelf TDFs, Glasgow says. Some sponsors saw a fiduciary risk in

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utilizing underlying proprietary funds that did not meet a plan's stated screening criteria. In sticking with off-the-shelf TDFs that have a standardized glide path and use proprietary underlying investments versus moving to custom TDFs that have a customized glide path and use best-of-breed investments in various asset classes, he says, "A sponsor is kind of making a compromise there. The question is, which compromise represents more risk? Our perspective has been, there's a lot to choose from off the shelf. For the time being, I'm okay with allowing the proprietary asset-management component to be the thing that we give up."

Partly because most plans still don't use custom target date funds, and partly due to the long investing timeframe, the industry has yet to really see if using custom TDFs truly brings participants value in long-term outperformance, Peluse says. "Off-the-shelf target date funds are so popular. There is safety in numbers for sponsors," diMayorca says. "And they are working: They seem to be doing an adequate to very good job. So why make a move? Plan sponsors, once they go through an exhaustive process to select a QDIA (qualified default investment alternative), rarely change it."

Intel Lawsuit Issues

Amid all those considerations, the lawsuit over Intel's custom target date funds looms.

No one knows how the Intel lawsuit will get resolved. But the suit points to several issues to consider about custom target date funds, says Isaac Presley, director of investments at Portland, Ore.-based Cordant Wealth Partners, which focuses on wealth management for Intel employees and Intel retirees with at least $500,000 in assets.

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Cordant's work with clients includes making recommendations on how they should invest in Intel's 401(k) plan.

Presley, without commenting on the lawsuit's merit, discussed three key allegations the suit makes:

1. Unusual Allocations

How much can a sponsor DB-ize 401(k) investments? Intel's target date funds — with their substantial allocations to hedge funds and private equity — don't resemble the balanced fund-type allocation typically seen in target date funds. Presley attributes that to the Intel funds' use of an investment strategy based on the "Yale Model," developed by Yale University's endowment fund and now used by many pension plans, endowments and foundations.

The Yale Model puts a lot of emphasis on use of alternative and illiquid assets to get diversification, Presley says, and that leads to lower-than-typical allocations to blue-chip stocks and investment-grade bonds. "So they moved into hedge funds and private equity and other illiquid investments," he says. "Not a lot of defined contribution plans traditionally use those investments. By definition, it makes the allocation look a lot different."

2. Risky Investments

The lawsuit says the plan's investment committee knew, or should have known, that the allocations exposed participants to the risk of substantial losses. Modern Portfolio Theory looks at risk on a portfolio-wide basis, Presley says, pointing out that hedge funds can lower portfolios' overall risk during equity bear markets. "You could have two investments that, judging by the standard deviation, could be high risk. But when you put them together, they could lower the risk for the portfolio overall," he says. "You have to look at risk at the portfolio level, at how much you are paying for that risk, and the most important thing is to look at the investor's objectives." The lawsuit ultimately speaks less to the different allocation strategy itself than that allocation's underperformance during a time period when U.S. equities performed well, he says. "Had the funds outperformed, I doubt the lawsuit would have been filed," he adds.

3. High Fees

The Intel custom target date funds average 130 basis points in fees, Presley says. "That's one of the primary reasons we suggest to our clients that they don't use these funds," he says. Intel's 401(k) plan has a good lineup of core funds, he says, and participants "have the ability to build a very low cost, diversified portfolio for much less than that."

Asked about the fees, Presley says, "Part of it is that they are using hedge funds and private equity, which tend to be higher cost. The other part of it is that even for the equity allocations, they're using actively managed funds, which tend to have higher expenses than index funds." Of course, sponsors don't have to pick the cheapest funds, but the ones with the best overall value for that plan's participants.

However it turns out, Lawton says the Intel lawsuit raises important issues about using custom funds. "My gosh, the people at Intel must be pretty sharp: They have the resources to hire the best people in the industry," he says. "And yet, here is this lawsuit that says they are using the wrong underlying investments in their custom funds, that they are very expensive and performed poorly. This is a test case to show whether it can happen to any company out there. If it can happen at Intel, with all their sharp people, could it happen anywhere?"

» Judy Ward is a freelance writer who specializes in writing about retirement plans.