Target-Date Funds:
Achieving a High Adoption Rate

Using the enrollment form, TDFs can be presented so that participants must choose to either select a single TDF or be their own asset allocator.

BY JERRY BRAMLETT

"EVERY SOLUTION TO EVERY PROBLEM IS SIMPLE. IT'S THE DISTANCE BETWEEN THE TWO WHERE THE MYSTERY LIES."
— DEREK LANDY, AUTHOR, *SKULDUGGERY PLEASANT*

Self-directed DC plans became popular in the early '80s, two decades before target-date funds began to appear regularly in DC fund lineups. This would seem to indicate that innovation moves at a slow pace in the DC industry. The challenge today is avoiding taking another two decades to implement an effective means to help individual DC investors adopt this simple asset allocation solution.

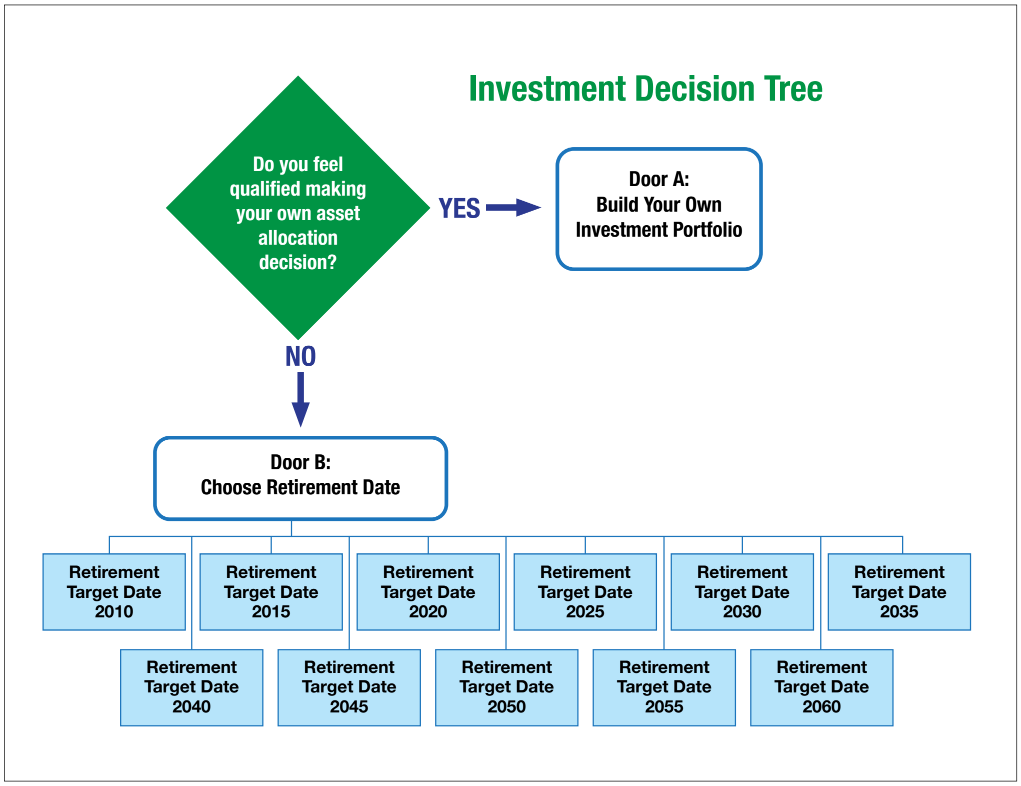
Since the emergence of self-directed DC plans, studies have consistently shown that individual investor return is predominantly (over 90%) tied to their asset allocation policy *(Brinson, 1986; Ibbotson, 2000)*. Behavioral finance studies have also found that the majority of DC investors have no idea how to best allocate their DC investments, with most tending to "divide their contributions evenly across the funds offered in the plan" *(Benartzi and Thaler, 2001)*.

An ever-increasing awareness of the near absurdity of what was being asked of participants — that is, to become their own asset allocators — gave rise to target-date funds and other asset allocation solutions. Target-date funds, for now, hold a clear lead in DC plans over other asset allocation strategies. However, for the purposes of this discussion, TDFs will serve as proxy for other asset allocation solutions, such as target-risk funds and managed accounts.

In spite of its popularity as an investment option, TDF adoption rates by participants remain unacceptably low. It is often said by a broad spectrum of plan advisors that 80 to 90% of all DC participants should be invested in structured asset allocation programs such as TDFs. These anecdotal surveys are supported by academic research which has found that, for example, "Using a rich new dataset on 1.2 million workers in over 1,500 plans, we find that most 401(k) plan participants are characterized by profound inertia." *("The Inattentive Participant: Portfolio Trading Behavior in 401(k) Plans," 2006)*.

Target-date funds represented approximately 16% of DC assets at the end of 2012. If balance funds and target-risk suites are included, that number increases to 25%. Managed accounts add another 2%. In total, less than 30% of DC assets are invested in asset allocation funds or programs *(McKinsey, 2010; Cerulli, 2012 and Callan, 2013)*.

Less than a 30% adoption rate of asset allocation solutions is far below what most plan advisors believe to be optimal. Taking into account that 56% of DC plans have an auto-enrollment feature *(DCIIA, 2013)* and



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typically default participants into TDFs, the voluntary uptake of TDFs is substantially lower.

Just as the "set and forget" principle at work in the structure of TDFs has made it easy for DC investors to establish a long-term investment strategy, what is needed is an equally simple strategy to enable participants to adopt these solutions. Unfortunately for most participants — even those with access to TDFs — there remains, at the time of enrollment, a confusing DC fund lineup. This makes it difficult for most investors to experience the clear distinction that exists between a single asset class fund and an asset allocation fund.

The most important challenge in ensuring that target-date funds have a high adoption rate is to make certain that participants view the selection of a single TDF as an all-in-one investment strategy. A recent survey reported that only 38% of target-fund investors and 27% of non-target date users understand that a TDF is intended to serve as "an all-in-one, hands-off investing" vehicle *(ING, 2012)*. The majority of DC investors with access to TDFs view them as just another investment option that are to be mixed with other options. Understanding this fundamental fact points toward the core challenge as it relates to increasing TDF adoption.

It is vitally important to present TDFs in such a way that the DC investor experiences the selection process as one in which there is a clear binary choice to be made:

- choose to be one's own asset allocator and, thus, be responsible for creating a custom mix from the available core asset classes; or
- select a single TDF.

This message can be a thread that runs throughout the enrollment literature. The reality, however, is that most DC investors do not read through the communication materials. Research has shown that even with the use of financial seminars, very few DC investors actually make any changes to their investment election *(Madrian and Shea, 2001)*. Consequently, teaching how to allocate among various asset classes is mostly a lost cause *(Benartzi and Thaler, 2007)*.

The one document that DC investors must read, and the one place where they have to commit to a decision, is the enrollment form that contains the investment allocation. An effective solution is to have an explanatory page overlaying the enrollment form that creates an unmistakable understanding as to the investment choice being made. If the enrollment is web-based, this cover page can be linked to a prepopulated enrollment page that only requires final authorization. If designed correctly, the adoption rates of a single TDF as an all-inclusive investment choice can be expected to reach as high as 80 to 90% among those DC investors who enroll.

The communication framework depicted above has been used in the enrollment of over a half million DC investors. This design has proven to be highly effective in helping DC investors adopt all-encompassing asset allocation strategies such as the use of a single target-date fund.

In this communication structure, participants see themselves as essentially having two investment choices that are presented in a binary fashion:

Door A: build their own asset allocation strategy

Door B: invest in a single TDF

To make this decision, participants need to understand only two things: (1) the importance of asset allocation; and (2) whether they feel qualified to manage their own allocation and, thus, effectively create and manage their own target-date glide path. Most importantly, this enrollment structure does not allow a DC investor to invest in more than one TDF *unless they choose to be their own asset allocator.* It is also important to note that, in this structure, nothing is being taken away from the participant. Instead this process simply clarifies their choice.

If DC investors choose Door A, then they are directed to another enrollment worksheet where they will allocate their plan accounts in the plan's investment options.

If the investors choose Door B, they are directed to an enrollment form that is prepopulated with that choice and, once authorized, they are done.

It really is just that simple.

» Jerry Bramlett was the founder, president and CEO of The 401(k) Company; and president and CEO of BenefitStreet. Bramlett and Peter Lynch, vice chairman of Fidelity Investments, ultimately acquired the assets of BenefitStreet and founded a new firm, NextStepDC, which was eventually sold. Currently Jerry is engaged in industry consulting and preparing for his next venture.