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Why target date fund oversight matters

Money management giant Vanguard began tracking the popularity of funds with professionally managed allocations — primarily target date funds (TDFs) — in 2003. Over the years, the organization has reported a steady growth of their prevalence in defined contribution retirement plans. As of the end of 2017, 58% of participants invested in a TDF, and Vanguard projects that that number will hit 77% by 2022.

The QDIA factor

One simple explanation of the growing dominance of TDFs is that they're one of the four categories of qualified default investment alternatives (QDIAs) permitted under the Pension Protection Act of 2006.

Vanguard's 2018 *How America Saves* report indicates that TDFs were the QDIA for 81% of the 1,900 plans and 4.6 million participants for which the organization provides recordkeeping services. In fact, 90% of participants joining a plan for the first time last year invested solely in a professionally managed allocation fund. And 97% of participants in plans handled by Vanguard have access to a TDF. (92% of the plans offer TDFs.)

Because TDFs aren't plan sponsors' only QDIA option, fiduciaries whose plans use TDFs as their QDIA should exercise due diligence to ensure a TDF is right for their participants. Here are some common criticisms to consider:

One size doesn't fit all. TDFs' implicit "one-size-fits-all" (participants of the same age bracket) structure can lull retirement investors into complacency with respect to their responsibility for understanding and monitoring investments. In addition, individuals' financial circumstances vary and have implications for optimum asset allocation. Participants who don't fit the TDF's demographic profile could be poorly served.

Bonds aren't risk-free. TDFs generally treat bonds as a more conservative investment than stocks, and shift their allocations more heavily to bonds as the plan participant approaches and enters retirement. But bonds

aren't risk-free. They can become overpriced and suffer a market "correction" just as much as stocks.

Portfolios generally diversify. TDF portfolios generally diversify using asset classes that are typically "noncorrelated": When one goes down in value, the other tends to go up. Stocks and bonds are considered noncorrelated asset classes. However, sometimes they move in the same direction. That can be good as well as bad but, in both cases, doesn't provide the intended diversification.

Fees are expensive. Because TDFs typically are a fund of funds, you can wind up paying two layers of fees. Those fees are more substantial for actively managed funds than for passive ones, of course. Thus, some TDFs are expensive from a fee standpoint, although both passive and active fund managers have been continually reducing their fees over the past several years.

Participants' responsibility

In 2013, the Department of Labor (DOL) released guidance titled "Target Date Retirement Funds — Tips for ERISA Plan Fiduciaries." In it, the DOL noted concern that participants who choose or are defaulted into TDFs can become complacent about their retirement investments. The DOL warned that participants who are responsible for investing their individual accounts need to understand TDF basics just as plan sponsors do.

For its part, Vanguard appears confident that the benefits of TDFs — particularly when participants are automatically enrolled in them — outweigh possible concerns. Behavioral finance research, according to Vanguard, shows among other things that, when left to their own devices, participants:

- Have weak planning skills and find it difficult to defer gratification,
- Take the default or "no decision" choice when faced with a complex choice and are unsure what to do, and
- Deal with a difficult choice by deferring it to another day.

With plan sponsors auto-enrolling participants into TDFs in greater numbers in recent years, the largest proportion of participants that invest exclusively in TDFs consists of those who are relatively young and, thus, have lower than average account balances and job tenure. Even so, according to the Vanguard report, two-thirds of plan participants invest exclusively in a single TDF, and 26% invest in a TDF plus other funds.

Time to decide

Will TDFs take over the world of defined contribution plans? Perhaps not completely, though the trends point in that direction. Plan sponsors should study the DOL's guidance to make sure they and their participants understand the overall pros and cons of TDFs — especially how any given TDFs are managed and likely to perform.

TDF diversity

To put matters into perspective, most of the criticism of target date funds (TDFs) isn't about the basic concept, but about the distinguishing features of particular TDFs. Such differences — including glide paths, investment strategies and fees — "affect the way a TDF performs," says the Department of Labor (DOL).

The DOL has expressed concern that many plan sponsors may take an "if you've seen one TDF, you've seen 'em all" posture. In response, it issued a set of "Tips for ERISA plan fiduciaries" on how (and why) to check under the hood of each TDF fund array. This advice is still valid.

Instead of just beginning its tip sheet with a checklist of TDF evaluation criteria, the DOL urges plan sponsors to "establish a process for comparing and selecting TDFs," as well as periodically reviewing selected TDFs. Remember, TDFs are no different from other managed investments in that their strategies, management teams, fee structure and performance against suitable benchmarks aren't static.

Compliance Alert

Upcoming compliance deadlines:

10/1 First day to distribute qualified default investment alternative (QDIA), safe harbor, and automatic contribution arrangement annual notices to plan participants (no earlier than today)

10/1 Deadline for establishing a new safe harbor 401(k) plan

10/1 Deadline for setting up a SIMPLE for 2018

10/15 Extended deadline for filing 2017 Form 5500

10/15 Deadline for funding employer profit sharing contributions and employer matching contributions

10/15 Extended deadline for filing 2017 Form 8955-SSA

10/15 Extended deadline for filing 2017 individual tax returns

10/15 PBGC Comprehensive Premium filing and payment deadline

11/1 2018 SIMPLE notice due to current participants

11/15 Deadline for distributing summary annual report *if* the IRS Form 5500 filing extension was due to the plan sponsor's tax return extension

Investment option overload?

A cautionary tale from Yale University

When it comes to defined contribution plan investment options, giving participants an abundance of choices can backfire. Yale University recently dodged a bullet in this regard when it beat back — at least initially — a class action lawsuit accusing the institution of an ERISA breach. Although the trial court granted Yale's motion to dismiss on the specific claim, the case is instructive for plan sponsors.

100+ investment options

Yale's plan had more than 100 investment options, including as many as 28 within a single asset class. That, according to the plaintiffs, "placed a monumental burden on participants in selecting options in which to invest." Participants would have been better served, they argued, if Yale had narrowed the choices to a few "best-in-class" funds within each asset category.

Some of the best-in-class funds in the Yale plan (as measured by investment performance) also had lower fees. The plaintiffs' complaint argued that reducing the number of investment options would concentrate the plan's assets into a smaller group of funds and annuities. This would, in turn, increase Yale's ability to demand lower share prices and qualify for less expensive institutional shares.

Yale filed a motion to dismiss the case without a trial. The judge ruled the case could proceed on other charges, but not the excessive investment option issue.

Although the court didn't reject the principle that participants could be harmed by excessive investment choices, the judge concluded that the plaintiffs merely hadn't presented sufficient evidence. While the plaintiffs discussed behavioral economics and "decision paralysis," the complaint didn't allege a theory of harm or provide facts explaining how the "dizzying array" of choices harmed them.

Plan sponsors can assess whether they're offering the right number of fund choices by surveying participants about why they have made their choices.

Magic number

So what about research showing that people make better choices when given a smaller number of options? For example, a 2011 paper published by the Harvard Business School, titled "When Smaller Menus Are Better: Variability in Menu-Setting Ability," concluded that people "find that smaller menus are objectively better than larger menus."

Another study, "Choice proliferation, simplicity seeking, and asset allocation," published by the *Journal of Public Economics*, evaluated data on the behavior of 500,000 employees and 638 plan sponsors from the Vanguard Center for Retirement Research. It found that, for every additional 10 investment options available, participants' equity allocation dropped by 3%, with a similar increase in the number of participants who allocate none of their retirement funds to equities.

And there is yet another consideration for plan sponsors: the relationship between the number of fund options and plan administration fees. Inevitably, the cost of recordkeeping and plan administration services is tied to the complexity of plans. So too are auditing fees. Unless the plan sponsor absorbs those costs, participants are arguably harmed by the additional expense.

Benchmark for perspective

The Plan Sponsor Council of America's *60th Annual Survey of Profit Sharing and 401(k) Plans* reflects that the average number of funds available for participants is between 18 and 20. All of this begs the question: Is there an ideal number of funds? The answer is elusive — and it would vary anyway according to each plan's demographics — but benchmarking can still be illuminating.

In addition to looking at benchmark data, plan sponsors can assess whether they're offering enough — but not too many — fund choices by periodically reviewing where participants are putting their money, and surveying them about why they have made their choices.

If, for example, many participants arbitrarily split up their dollars earmarked for U.S. equities into multiple funds with similar goals but dissimilar performance track records, that might suggest your fund lineup within that category could use some winnowing. The same could be true if polling reveals that many participants are suffering from "decision paralysis."

Take a look

Avoiding litigation in the first place is better than being hauled into court. This case should be an impetus for many sponsors to take a closer look at the array of funds offered in their qualified retirement plans.

Investing in HSAs for long-term retirement goals

Retirement plans are about saving for the cost of living in — retirement. And typically one significant expense for retirees is medical bills. Actuaries at Fidelity Investments estimate that a typical 65-year-old couple retiring in 2018 will incur $280,000 in combined out-of-pocket health expenses during their retirement, *excluding* the cost of long-term care.

Why HSAs?

Employers can offer Health Savings Accounts (HSAs) only in combination with their high-deductible health plans (HDHPs). These accounts can be a tax-efficient way to cover medical expenses because they're designed to be "triple tax-free." Here's how that works:

1. Tax-deductible employee contributions. Contributions to an HSA (capped at $3,450 for employees with single coverage, and $6,900 for those with family coverage in 2018) are tax-deductible, whether or not employees itemize their deductions. Employee contributions are contributed pretax.

2. Tax-free interest and earnings along with any employer contributions. Employees aren't taxed on any funds contributed to their HSAs by their employer and the growth due to interest and/or investment gains is tax-free. (Employer contributions to HSAs are strictly optional.)

3. Tax-free withdrawals for medical expenses. Retirees aren't taxed on funds withdrawn from their HSAs to pay for eligible medical expenses. From age 65 onward, HSA funds used for nonmedical expenses are taxed as ordinary income, as is the case with non-Roth IRAs and defined contribution plans. Early withdrawals before age 65 for nonmedical expenses are subject to a 20% penalty on top of regular income tax, unlike the 10% premature distribution from a qualified retirement plan.

Employers can offer HSAs only in combination with their high-deductible health plans.

What's the trend?

Originally, HSAs were conceived as a tax-friendly way to help employees pay for their deductibles in their HDHPs. Increasingly, however, people are looking at HSAs as a hybrid retirement savings vehicle. According

to Devenir Research, 18% of HSA assets today are invested for long-term growth, instead of simply being set aside in cash accounts for short-term use. That's up from 11% five years ago.

Earlier this year, the U.S. Securities and Exchange Commission issued an "investor bulletin" with tips on using HSAs. Among the tips was a reminder that, like 401(k) accounts, HSAs are portable. So employees can move them to another financial institution if they leave your company. And, unlike Flexible Spending Accounts, balances can be rolled over from year to year without any dollar limitation. Be sure to remind departing participants to research HSA custodians, focusing on investment options and fees. □

New IRS preapproved plan regime takes effect

Last year, in Revenue Procedure 2017-41, the IRS announced a new regulatory regime for defined contribution plans. The regime was issued, according to the agency, "to expand the [plan] Provider market and encourage employers that currently maintain individually designed plans to convert to the pre-approved format."

Rev. Proc. 2017-41 set a deadline of October 1, 2018, for prospective submitters of "pre-approved" defined contribution plan documents to conform with the new regime. Here's what affected employers should know going forward.

(Non)standardized plans

The principal effect of the revenue procedure was to consolidate preapproved "master," "prototype" and "volume submitter" plan document types into a simplified categorization system. Now they're either "standardized" or "nonstandardized" preapproved plans. The IRS hopes that, the more employers that use preapproved plan formats, the less time it will have to spend reviewing customized plan documents.

Standardized preapproved plans basically come under the safe harbor heading, meaning the employer has fewer plan design choices. Safe harbor plan design requirements, while limiting sponsors' exposure to regulatory problems, tend to err on the side of generosity to plan participants. An employer using a standardized preapproved plan can rely on the opinion letter issued to the preapproved plan "as if it were its own determination letter."

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Nonstandardized preapproved plans, in contrast, don't need to satisfy safe harbor standards, and sponsors can make minor modifications to the plan. However, if the IRS were ultimately to decide that modifications were more than minor — it's not always clear-cut — there could be trouble. When in doubt, instead of relying on the authority of the IRS's affirmative opinion letter issued to the plan document's creator, a plan sponsor can file its own determination letter using IRS Form 5307.

2 plan formats

Employers can submit preapproved plans in one of two formats:

1. An adoption agreement plan. This consists of the plan document itself and the adoption agreement. The sponsor cannot tinker with the approved plan document, but it does have some wiggle room with the adoption agreement.

2. A single-document plan. An adoption agreement isn't included here; the document contains all available optional and alternative paragraphs.

More terminology

The following categories of qualified plans previously ineligible for preapproved plan treatment now have that opportunity:

- Employee stock ownership plans with 401(k) features,
- Combined profit sharing, 401(k) and money purchase plans that are all rolled into a single plan document,
- Cash balance plans that base the interest crediting rate on actual rates of return, and
- Church plans.

Finally, though Rev. Proc. 2017-41 removed the term "volume submitter," it added the similar-sounding "mass submitter." These are businesses that submit "opinion letter applications on behalf of at least 30 unaffiliated providers that have 'word-for-word identical' plans to the mass submitter's pre-approved plan." Because they streamline the IRS review process, mass submitters are given expedited treatment.

What's the impact?

Rev. Proc. 2017-41 made many language changes, some of which may affect your plan. Contact your plan administrator to learn more.

The solution for skyrocketing audit fees

Finding ways to cut costs while maintaining quality seems to be at the top of every executives to do list. As the person responsible for your organization's employee benefit plan audit, we can help you not only reduce your audit costs but also provide a higher level of service.

Pension auditors must sift through enormous amounts of financial data in accordance with the requirements of numerous laws, regulations and professional standards. If they don't know what they're doing, they can easily get lost in the numbers, run up large fees and fail to provide an accurate assessment of a plan's financial status.

Pension audit specialists

Insero & Co. specializes in pension plan audits. Our professionals have extensive experience in this area and to ensure that our audits meet the highest standards of quality, our firm is a member of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center and is registered with the Public Company Accounting Oversight Board (PCAOB).

Insero & Co. is the independent registered public accounting firm for many companies that file a form 11-K with the Securities and Exchange Commission. We currently perform audits for more than 150 plans ranging in size from 100 to 60,000 participants, and from $1 million to more than $10 billion in assets.

Big firm capabilities, small firm attentiveness

As our many satisfied clients will testify, we offer the comprehensive benefit services of a large national firm, but at less cost and with a higher level of service. With more than 125 accountants, professional consultants and support staff, our firm is large enough to bring robust resources to bear on almost every client need, yet small enough to provide the personal attention and relationship-based service that is important to our clients.

The culture of Insero & Co. is hands-on and proactive, shaped by the old-fashioned notion of doing what is in the best interest of the client. In addition to pension and corporate audits, we provide a full range of tax, accounting and consulting services, including internal audit/Sarbanes-Oxley services, outsourced accounting and wealth management.

Go with the experts

We would welcome the opportunity to discuss your audit or other needs and put our expertise to work for you. Please contact Vince Leo at 585-697-9683 or Mike Giess at 585-697-9639 and let us know how we can be of service.