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This guidebook highlights certain investment features and other factors which may be considered by plan sponsors and other fiduciaries in evaluating target date funds. The definitive factors which should be considered in a fiduciary review of target date funds have not been specifically addressed in regulatory or interpretive guidance as of the publication date of this guidebook. Future legislative or regulatory developments may significantly impact target date funds and provide more definitive guidance as to how such funds are to be evaluated. Please be sure to consult with your own legal counsel concerning such future developments.

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INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE
Executive summary

Target date funds (TDFs) have become a widely used investment option for 401(k) plans and participants. However, the U.S. Government Accountability Office (GAO) recently concluded that plan sponsors may face several challenges in evaluating TDFs, such as having limited resources to conduct a thorough selection process. Plan fiduciaries have a duty to ensure the plan’s investment funds, including any TDFs, have been selected in accordance with the high standards of care under ERISA, including the duty of prudence. If a plan sponsor approves the use of a particular TDF series in a manner that violates these high standards of care, the plan sponsor could be held accountable for losses incurred by participants as a result of their investment in the TDFs.

To discharge this duty, the plan sponsor should conduct an independent investigation of the merits of its particular TDF series, giving appropriate consideration to the relevant investment characteristics and features of the series and its component funds. Key concerns to consider may include:

‘Glide path’ and underlying funds
In light of the typical “fund of funds” structure of TDFs, plan sponsors should consider giving special consideration to the TDF series’ glide path and its underlying funds. (For more information on these topics, see pages 8 and 9.)

Timing of reviews
In general, fiduciary reviews should be conducted before the initial selection of a TDF series for the plan, and also on an ongoing basis at reasonable intervals.

Need for qualified assistance
If the plan sponsor does not have the necessary expertise to conduct this review alone, the sponsor should seek the assistance of a qualified financial advisor or other investment professional.

Changes in fund selection
If a plan sponsor does not wish to approve the use of a particular TDF series, it can be replaced with another TDF series or a different type of balanced fund. If the particular TDF series is bundled with administrative services, the TDF option could also be removed (without being replaced) or, as a last resort, another administrative service provider could be selected.
Many 401(k) plan sponsors have approved the use of target date funds

TDFs are a special type of balanced fund which invests in a mix of asset classes, automatically shifting to a more conservative asset mix as a stated target date approaches in accordance with a predetermined “glide path.” Thanks to the appeal of this automatic asset allocation feature, TDFs have become a widely used investment option for 401(k) plans and participants.

Much of their popularity is attributable to the Pension Protection Act of 2006, which encouraged 401(k) plan sponsors to enroll participants automatically and to allocate their investments to a default option. In 2007, the U.S. Department of Labor (DOL) approved the use of TDFs as a “Qualified Default Investment Alternative” (QDIA). Approximately 87% of 401(k) plans with automatic enrollment features currently use TDFs as their default investment.¹ As of December 31, 2011, the total investment in TDFs has swelled to about $378 billion.² Many 401(k) plan sponsors have already added TDFs to their plan menus, and others are strongly considering them for their plans.

Plan sponsors may face several challenges in evaluating TDFs

The U.S. Government Accountability Office (GAO), an independent federal agency tasked with serving as the “watchdog” for Congress, recently concluded that plan sponsors may face several challenges in evaluating TDFs, such as having limited resources to conduct a thorough selection process. The GAO also found that TDFs varied considerably with respect to investment performance, asset structures and in other ways, largely as a result of the different investment philosophies of the fund managers. Historically speaking, between 2005 and 2009, the annualized TDF returns for the largest funds with 5 years of returns ranged from +28 percent to -31 percent.

The GAO’s research and pronouncements on TDFs provide a helpful background for 401(k) plan sponsors and other plan fiduciaries responsible for the selection and monitoring of the TDFs for their respective plans. Plan fiduciaries have a duty to ensure the plan’s investment funds, including any TDFs, have been selected in accordance with the high standards of care under ERISA, including the duty of prudence. If a plan sponsor approves the use of a particular TDF series in a manner that violates these high standards of care, the plan sponsor could be held accountable for losses incurred by participants as a result of their investment in the TDFs.

Plan sponsors have a duty to investigate the merits of their TDFs

Plan sponsors and other fiduciaries are generally charged with carrying out their duties prudently and solely in the interest of participants, and they are required to make good any losses that result from a breach of their duties. The cornerstone of the various fiduciary duties imposed on plan sponsors is the duty of prudence under Section 404 of ERISA. This duty requires a fiduciary to act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

With respect to investments, this duty requires plan fiduciaries to conduct an independent investigation of the merits of the particular investment. This duty is procedural in nature, and the test of prudence is an examination of the fiduciary’s process for arriving at its investment decision. It is not a hindsight evaluation of the investment based solely on its performance.

Additionally, in considering any investment course of action, a plan sponsor must give “appropriate consideration” to those “facts and circumstances” that the fiduciary should know are “relevant” to the particular investment involved, including the role the investment plays in the plan’s investment portfolio. For purposes of this rule, the plan sponsor must make a determination that the particular investment is reasonably designed, as part of the plan’s portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain.

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4 GAO-11-118 (January 2011).

5 ERISA Section 404.

6 ERISA Sections 403, 404 and 409.

7 Section 404(a)(1)(B) of ERISA.

8 See, e.g., Donovan v. Cunningham, 716 F.2d. 1455 (5th Cir. 1983), cert. denied, 469 U.S. 1072 (1984).

9 See also, e.g., In re Unisys Savings Plan Litigation, 74 F.3d. 420 (3d Cir.) cert. denied, 519 U.S. 810 (1996).

10 29 C.F.R. 2550.404a-1(b)(1).
Thus, when a 401(k) plan sponsor is considering the addition, or the continued use, of a TDF series for the plan’s investment menu, it should conduct an independent investigation of the merits of the particular TDF series. It should also give appropriate consideration to those facts and circumstances that it knows to be relevant to the TDF series, including the role that the TDF option is intended to play in the 401(k) plan. When making this assessment, plan sponsors should bear in mind that the role of a TDF series in a 401(k) plan’s investment menu is fundamentally different from that of other menu options in two key respects.

First, a participant may reasonably be expected to invest his or her entire account balance under the plan exclusively in a single TDF. Typically, the automatic asset allocation feature of a TDF is premised on the assumption that the participant will not be making one-off investments in other funds.

Second, a participant may reasonably be expected to choose a specific TDF from the available TDFs in the series based, at least in part, on the participant’s anticipated year of retirement. Thus, the TDF with the furthest retirement year is intended for the youngest investors, and the “retirement income” TDF is intended for retirees. The other TDFs in the series are intended for those who are in between those age demographics.

When considering the initial selection or the continued use of a TDF series, the 401(k) plan sponsor should consider the risk of loss and the opportunity for gain with respect to each TDF in the series and whether each individual TDF in the series is reasonably designed to satisfy the retirement investment goals of the participants in the applicable age demographic. Not all TDFs are built the same way.

12 GAO-11-118 (January 2011).
Not all TDFs are built the same way. More than 45 different fund families offer their own lines, or series, of TDFs. Even though TDFs from different fund families may share the same “target date” year in their names, they do not necessarily share the same investment characteristics. As discussed above, historically speaking, the annualized returns for the largest TDFs with 5 years of returns between 2005 and 2009 ranged from +28 percent to -31 percent.\textsuperscript{12}

The investment features that distinguish one TDF series from another fund family’s TDF series are wide-ranging and complex. Such complexity arises from the prevailing “fund of funds” (or tiered) investment structure of TDFs. Instead of investing in portfolio securities directly, a TDF typically invests in other mutual funds. As a result, an evaluation of any TDF structured as a fund-of-funds necessarily requires an understanding of the underlying funds in which the TDF invests and how the mix of investments across the portfolio of underlying funds changes over time (i.e., the glide path).\textsuperscript{13} Of course, in addition to considering a TDF series’ glide path and its underlying funds, plan fiduciaries should also consider the qualifications of the TDF series’ investment manager and all other relevant facts and circumstances.

Plan sponsors should never “turn a blind eye” to a TDF’s underlying investments on the flawed assumption that the TDF’s investment manager has accepted this responsibility as an ERISA fiduciary on their behalf. For ERISA purposes, the investment manager of a plan’s selected TDF series is not a plan fiduciary.\textsuperscript{14} Thus, plan sponsors are alone in their ERISA fiduciary duties to evaluate all the relevant aspects of a selected TDF series, and they should consider giving special consideration to the TDF’s glide path and its portfolio of underlying funds, as described below.
Special considerations when reviewing the glide path of TDFs

One of the critical features of a TDF series is its glide path, which determines the current asset mix of all the TDFs in the series as well as the future asset mix of each individual TDF. Glide path information is generally available in the TDF’s prospectus. When reviewing the glide path, plan fiduciaries should consider making the following inquiries:

Creation of the glide path. What investment philosophy and methodology was used to create the glide path? Was any kind of stress testing or modeling used to assess how robust the glide path might be in different environments? What were the qualifications of the creators of the glide path, and do they have expertise in asset allocation analysis?

Equity exposure. For each TDF in the series, identify the percentage of the fund’s investments in equity. Given the applicable level of equity exposure, is each TDF’s investment risk appropriate for the intended demographic of participants? It may be helpful to look at this risk from the perspective of a handful of representative participants.

Risk management. Given the recent volatility of equity markets, many TDFs have revisited their overall philosophy for managing downside risk. Does the TDF series have a considered approach for addressing this risk? Special consideration should be given to near-term TDFs in the series (e.g., 2015 TDF).

Slope of glide path. What is the “slope” of the TDF series’ glide path? Does it reduce the level of equity exposure ratably over time, or does the equity exposure remain relatively high and then decline steeply only near the end of the glide path? Is the slope of the glide path appropriate for all phases of a participant’s life cycle?

“To” or “through” retirement. Since the average 65-year-old is expected to live another 21 years, many TDFs extend their glide paths “through” retirement. Some may not reach a final asset mix until 20 or 30 years after the target year. Does the TDF glide “to” or “through” retirement? Is the post-retirement phase of the glide path appropriate?

Rebalancing. Because a TDF’s underlying investments may appreciate and depreciate at varying rates, the asset mix may drift from the glide path. How far may the asset mix drift from the mix prescribed in the glide path? How and how often is rebalancing done? Does the TDF manager have an appropriate process for rebalancing?

Tactical asset allocation. Does the TDF manager have the ability to make tactical changes to the asset mix that depart from the glide path? If so, are there any restrictions on this ability? Is this discretion intended to provide downside protection to investors? Does the investment manager have expertise in tactical asset allocation analysis?

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Asset allocation does not assure a profit or protect against market loss.

Based on IRS Single Life Table used for determining the life expectancy of an individual for purposes of required minimum distributions. Section 1.401(a)(9)-9, Q&A-1 of Treasury Regulations.
Special considerations when reviewing the underlying funds of TDFs

Another critical feature of a TDF series structured as a “fund of funds” is its portfolio of underlying funds. Typically, the names of the underlying funds and other information can be found in the TDF’s prospectus. When reviewing the underlying funds, plan fiduciaries should consider making the following inquiries:

**Asset classes and categories.** Which asset classes and categories are represented by the various underlying funds? Do such asset classes and categories allow for appropriately diversified TDF investment portfolios?

**Investment strategy of underlying funds.** Do you understand the investment strategy and associated risks of investing indirectly in the various underlying funds? Review their historical performance, which may be available in the TDF’s prospectus.

**Multi-manager capabilities of fund family.** Are the managers of the underlying funds affiliated with the same fund family? If so, does the fund family have the necessary capabilities to support a multi-manager, multi-asset-class investment strategy?

**Active vs. passive management.** Are the underlying funds actively or passively managed? When a fund is actively managed, investors benefit from the expertise of its manager. A passively managed fund typically has lower operating expenses.

**Manager-level diversification.** When multiple investment managers specialize in the same asset class but use different sources of information and investment processes, diversification can be achieved at the manager-level. Does the TDF invest in different and diverse funds in the same asset classes, resulting in manager-level diversification?

**Fees and expenses.** In addition to paying any fees and expenses associated with the operation of the TDF itself, participants are also indirectly paying the fees and expenses of the TDF’s underlying funds. In many instances, the TDF-level operating costs are relatively small in comparison to those of the underlying funds. Taking into account the indirect costs of the underlying funds, is the total cost of each TDF reasonable?

**Problems with an underlying fund.** Is any underlying fund objectionable because of poor performance or any other reason? If so, this conclusion should not result in the automatic rejection of the entire TDF series, and the underlying fund at issue should be evaluated in its proper context. The applicable fund’s role as an underlying investment for the TDFs should be weighed and considered along with all relevant facts to determine if the TDF series is a suitable and prudent investment choice for participants.
Implementing a prudent review process to evaluate the plan menu, including TDFs

Generally, in the case of 401(k) plans, the plan sponsor is responsible for the selection of investment options for the plan’s menu, including any TDF option, and each participant is responsible for the allocation of his or her account balance across the plan’s available investment options. Special fiduciary relief is available to 401(k) plan sponsors so that they are not held responsible for the individual allocation decisions of participants.16

Plan sponsors remain subject to ERISA’s general fiduciary standards in both (1) the initial selection of any investment menu options, including TDFs, and (2) the ongoing determination that such options “remain suitable and prudent investment alternatives for the plan.”17 Thus, once a TDF series and any other investment alternatives are selected for the plan, the fiduciary has an ongoing duty to monitor investments with reasonable diligence and to remove plan assets from any investment that is improper.18 This duty to monitor plan investments prudently also applies to any QDIA selected for the plan.19

It is the view of the DOL “that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring.”20 If a fiduciary lacks the education, experience, or skills to be able to conduct a reasonable, independent investigation and evaluation of the risks and other characteristics of the proposed investment, the fiduciary must seek independent advice.21 Thus, unless they possess the necessary expertise to evaluate such factors, plan fiduciaries would need to obtain the advice of a qualified expert.22

Plan sponsors can satisfy these fiduciary requirements under ERISA with a prudent review process. This process does not need to be laborious or time-intensive, but the review should be purposeful. If the plan’s investment menu includes a TDF series, the plan sponsor should consider incorporating the inquiries described in this guidebook in its fiduciary review. Reviews should be conducted on a regular basis, such as annually or at other reasonable intervals. Consistent with DOL guidance, a written record of each review should be maintained to demonstrate that the plan sponsor is conducting fiduciary reviews of the plan’s investment options on an ongoing basis. If a 401(k) plan sponsor does not have the necessary investment expertise to conduct a comprehensive fiduciary review, the employer should seek the assistance of a qualified financial advisor or another investment professional.

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16 Sponsors of participant-directed retirement plans, such as 401(k) plans, qualify for this special fiduciary relief by satisfying the conditions of Section 404(c) of ERISA.
19 29 C.F.R. 2550.404c-5(b)(2).
20 DOL Interpretive Bulletin 94-2.
22 See, e.g., U.S. Department of Labor Interpretive Bulletin 95-1.
Considering changes to plan’s TDF series or removal of TDF investment option

One of the advantages of performing a regular review of the plan’s TDF series is that the plan sponsor can have a measure of confidence that these funds are properly satisfying the investment needs of plan participants. Another advantage is that, even if a TDF were to underperform for an unforeseen reason, the plan sponsor would not be responsible under ERISA for the corresponding losses suffered by plan participants. Of course, to enjoy this protection from fiduciary liability, the plan sponsor would need to demonstrate it had conducted an independent investigation of the merits of the TDF series and that it had properly concluded that the TDF series was a suitable and prudent investment choice based on this investigation.

If the plan sponsor is unable to reach a favorable conclusion in connection with its review of the TDF series, it must take action to remove the imprudent investment option from the plan as soon as possible. One potential approach would be to replace the applicable TDF series with another TDF series from a different fund family. This approach may be problematic if the plan’s recordkeeper has “bundled” or otherwise conditioned its administrative services on the continued use of the same TDF series. A potential solution to this problem may be to replace the TDFs bundled with the recordkeeper’s services with another type of balanced fund, such as a lifestyle fund, from the same fund family preferred by the recordkeeper.

In the alternative, a plan sponsor could always eliminate a TDF series from the plan’s menu without replacing it with another option. Such action may be necessary in situations where the plan’s recordkeeper does not allow the use of an alternative TDF series (or the use of any other type of balanced fund as a substitute investment option). If the applicable TDF series is the plan’s QDIA, the permanent removal of the default investment option may also necessitate the elimination of the plan’s automatic enrollment feature. As a last resort, the plan sponsor could consider switching to a different administrative service provider that does not place such onerous restrictions on the selection of TDFs or other balanced funds for the plan menu.

Conclusion

Sponsors of 401(k) plans with TDF investment options should ensure that the plan’s selection and continued use of its TDF series is in accordance with the high fiduciary standards of ERISA. To satisfy ERISA’s duty of prudence, every plan sponsor should conduct an independent investigation of the merits of its TDF series and give appropriate consideration to the relevant investment characteristics and features of the TDFs. In light of the typical “fund of funds” structure of TDFs, plan sponsors should consider giving special consideration to the TDF series’ glide path and its underlying funds. Reviews should be conducted on an ongoing basis, and if the plan sponsor does not have the necessary expertise to conduct this review alone, the plan sponsor should seek the assistance of a qualified financial advisor or another investment professional.
Addendum

QDIA considerations for target date funds

TDFs and QDIA Regulations

Many 401(k) plans have automatic enrollment features for their eligible employees. If an eligible employee does not opt out, he or she is automatically enrolled in the plan and the participant’s payroll contributions are automatically invested in the plan’s default investment. In many cases, the plan’s default investment for the participant is a target date fund (TDF) series. Each TDF in a TDF series is typically a “fund of funds” investment product, where the TDF is an overlying mutual fund which invests in a mix of underlying mutual funds or exchange-traded funds (e.g., fixed-income funds and equity funds).

ERISA offers a special kind of fiduciary liability protection for sponsors of 401(k) plans with default investments. So long as the requirements of ERISA Section 404(a)(5) and the related regulations (the “QDIA Regulations”) are met, the plan’s fiduciaries are relieved of any ERISA liability relating to investment losses that are the direct result of a participant being defaulted into the plan’s default investment.

One of the key requirements under the QDIA Regulations is that the plan’s default investment must qualify as a qualified default investment alternative (“QDIA”), as defined under the QDIA Regulations. If the various conditions of the QDIA Regulations are satisfied, the defaulted participants alone are responsible for their “passive” investment decision to invest in the QDIA by default.

Although the fiduciary liability relief available under ERISA Section 404(a)(5) is broad in its nature, it is not absolute. The QDIA Regulations expressly provide that the plan’s responsible fiduciary must prudently select and monitor the investment option designated as the plan’s QDIA, and that the fiduciary remains liable for investment losses that result from a failure to satisfy these duties. Thus, even if the plan’s default investment constitutes a QDIA, the plan sponsor remains responsible for ensuring that the plan’s QDIA is a prudent investment choice for defaulted participants.

This Addendum addresses how plan sponsors may wish to evaluate one or more TDF series that are being considered for selection as the plan’s QDIA and how plan sponsors may monitor on an ongoing basis a TDF series that currently serves as the plan’s QDIA.
Compliance with QDIA conditions

The QDIA Regulations permit various types of investment vehicles to serve as a plan’s QDIA, including but not limited to target date funds which are organized or formed as mutual funds (i.e., open-end management investment companies registered under the Investment Company Act of 1940). The first step in evaluating the prudence of selecting a TDF series as a plan’s QDIA is confirming that the TDF series is in fact in compliance with the relevant qualification conditions for a QDIA under the QDIA Regulations. For a TDF series to qualify as a QDIA, it must satisfy the following conditions:

1. **Generally accepted investment theories.** The TDF series must apply generally accepted investment theories.

2. **Target date investment strategy.** The TDF series must be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant’s age, target retirement date or life expectancy.

3. **Diversification.** The TDFs must be diversified so as to minimize the risk of large losses.

4. **Glide path.** The TDFs must change their asset allocations and associated risk levels over time with the objective of becoming more conservative with increasing age. However, such asset allocation decisions need not take into account the risk tolerance, investments or other preferences of the individual participants.

When confirming that a TDF series complies with the Generally Accepted Investment Theories condition, the plan sponsor should review the fund prospectus and other related disclosures to ascertain the investment philosophy and strategy employed by the TDF’s fund manager. These disclosures should also enable the plan sponsor to confirm that the TDF is in compliance with the Glide Path condition.

For purposes of the Target-Date Investment Strategy and Diversification conditions, the TDFs must include a mix of both equity and fixed-income exposures. It should be noted that the DOL expressly requires each TDF in the TDF series to include some fixed-income exposure, and no investment product without any fixed-income exposure will qualify as a QDIA. Like all mutual funds, a TDF will presumably invest a small portion of its assets in cash equivalents (i.e., short-term investment notes or funds) for liquidity purposes to process the day-to-day redemptions of its fund shares. However, plan sponsors should not presume that a TDF’s cash liquidity investments will be sufficient for purposes of satisfying the DOL’s requirement to maintain some level of fixed-income exposure.

Although there is no minimum level of fixed-income exposure that is expressly mandated by the DOL, each TDF in a TDF series should have some level of strategic allocation to fixed-income investments (e.g., 3% of TDF’s portfolio) beyond the TDF’s cash liquidity investments. If a TDF does not include a mix of both equity and fixed-income exposures, the TDF series (of which such TDF is a part) would be ineligible to serve as a plan’s QDIA. Plan sponsors can readily confirm a TDF’s compliance with this requirement by reviewing the strategic or target allocation information in the TDF’s fund prospectus as well as the actual allocation information in the TDF’s fact cards and other relevant fund disclosures.

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*Diversification does not assure a profit or protect against market loss.*
QDIA considerations based on ERISA section 404(c) principles

Once the plan sponsor has determined that a TDF series is in compliance with the applicable conditions to qualify as a QDIA under the QDIA Regulations, the plan sponsor must prudently evaluate the TDF series to determine if it should be selected to serve as the plan’s QDIA. Unfortunately, other than stating that plan fiduciaries must prudently select and monitor the plan’s QDIA, the QDIA Regulations themselves do not provide any specific guidance on how plan sponsors should evaluate a TDF for QDIA selection purposes.

As discussed in the main body of this paper, as a general principle, a plan fiduciary must give appropriate consideration to those facts and circumstances that are relevant to the particular investment involved before making fiduciary investment decisions, including the role such investment is to play in the plan. Consistent with this general principle, when a plan sponsor considers the selection of a TDF series to serve as the plan’s QDIA, it should consider all relevant facts and circumstances, including the fact that the TDF series is a “fund of funds” investment product and that the TDF series is designed to serve as the all-in-one investment for defaulted participants.

As an all-in-one investment, the plan’s QDIA functionally replaces the portfolio that the defaulted participant would have otherwise created using the plan’s menu of investment options. ERISA Section 404(c) and the related regulations (the “404(c) Regulations”) provide instructive guidelines on how a plan’s menu may qualify as a “Broad Range of Investment Alternatives” for purposes of the 404(c) Regulations. Although these conditions do not formally apply to the selection of a plan’s QDIA, the guidelines for creating a Broad Range of Investment Alternatives can serve as an effective tool for plan sponsors, helping them evaluate the prudence of selecting a TDF series to serve as the plan’s QDIA.
The third condition, TDF Portfolio Appropriate for Plan Demographics, is an especially helpful consideration for plan sponsors in their fiduciary review of a TDF. When a plan sponsor selects a TDF series as the plan’s QDIA, each TDF in the series is customarily utilized as a default investment for a particular age-based grouping of participants. For example, the plan sponsor may designate a “2040” TDF to serve as the plan’s investment for all defaulted participants who are expected to turn ages 63 through 67 during calendar year 2040.

In order to confirm that a TDF’s portfolio of underlying funds has “normally appropriate” risk-return characteristics for the particular age-based grouping of participants, both in the present time and in the future as participants get older, the plan sponsor may wish to consider risk tolerance, investment preferences and the level of financial sophistication of such grouping based on the sponsor’s overall knowledge and understanding of its employee base.

For purposes of the fourth condition above, TDF Portfolio Minimizes Risk, the plan sponsor should confirm that the TDF’s portfolio of underlying funds tends to minimize a defaulted participant’s overall investment risk. This analysis should be made in light of the TDF’s desired risk-return characteristics for the relevant age-based grouping of participants. For example, a “2050” TDF that is intended for younger defaulted participants may be designed to maintain a relatively high level of equity exposure, and the plan sponsor should bear this in mind when reviewing how the TDF’s mix of investments in its underlying funds minimizes the overall risk of investing in such TDF.
Monitoring the plan’s QDIA

Once a TDF series has been prudently evaluated and selected to serve as a plan’s QDIA, the plan sponsor must monitor the TDF series to ensure that it remains a prudent QDIA selection on behalf of the plan. Since a plan’s defaulted participants may not be actively monitoring their investments in the plan’s QDIA, it is especially important for plan sponsors to be diligent in conducting their ongoing fiduciary reviews of the plan’s QDIA.

When monitoring the plan’s QDIA, in addition to gathering investment-related information, the plan sponsor should also gather information concerning the level of QDIA utilization and the type of participants who are being defaulted into the QDIA as well as information about demographic shifts or changes in the plan’s population of defaulted participants. All relevant information and any changes in such information should be considered for purposes of confirming that a TDF’s portfolio of underlying funds has “normally appropriate” risk-return characteristics for the particular age-based grouping of participants as described above in regard to the TDF Portfolio Appropriate for Plan Demographics condition.

Conclusion

As discussed in the main body of this paper, when selecting a TDF series as an investment alternative for a plan’s menu, the plan sponsor should conduct an independent investigation of the merits of the particular TDF series, giving appropriate consideration to the relevant investment characteristics and features of the series and its component funds. The plan sponsor should consider reviewing the TDF’s glide path, its underlying funds and all other relevant facts and circumstances.

If the plan sponsor intends to go a step further and designate the TDF series as the plan’s QDIA, the plan sponsor should perform an initial evaluation to confirm that the TDF series complies with the various conditions under the QDIA Regulations. Once this initial evaluation has been completed, the plan sponsor should also consider performing an evaluation of the TDF series based on the Broad Range of Investment Alternatives conditions under the 404(c) Regulations. Since each TDF in the TDF series will be utilized as a default investment for participants in a particular age-based grouping, the plan sponsor may wish to confirm that each TDF’s portfolio of underlying funds has “normally appropriate” risk-return characteristics for the relevant age-based grouping.

Consistent with the fiduciary standard of care under ERISA, if the plan sponsor does not have the necessary expertise to conduct its fiduciary review of the plan’s QDIA for any reason, the sponsor should seek the assistance of a qualified financial advisor or other investment professional.
Special considerations when reviewing TDF series as plan’s QDIA

TDFs and QDIA Regulations. ERISA offers fiduciary liability protection for sponsors of 401(k) plans with default investments. To be eligible for this protection, the default investment must qualify as a qualified default investment alternative, or QDIA, and certain other regulatory requirements must be met. When considering a TDF series to serve as a QDIA, in addition to reviewing each TDF’s glide path, underlying funds and all other relevant facts and circumstances, the plan sponsor should take additional QDIA-related considerations into account.

Compliance with QDIA conditions. For a TDF series to qualify as a QDIA, it must comply with the following relevant conditions:

1. TDFs apply generally accepted investment theories
2. TDFs provide a mix of equity and fixed-income exposures based on the participants’ age
3. Each TDF is diversified so as to minimize the risk of large losses
4. TDFs change asset allocations over time, becoming more conservative with increasing age

Each TDF in a TDF series should have some level of strategic allocation to fixed-income investments (e.g., 3% of TDF’s portfolio). If a TDF does not include a mix of both equity and fixed-income investments, the TDF series (of which such TDF is a part) would be ineligible to serve as a plan’s QDIA.

QDIA considerations based on 404(c) principles. Although the Broad Range of Investment Alternatives conditions under ERISA Section 404(c) do not formally apply to a QDIA, they can serve as helpful standards for evaluating a TDF and its underlying funds as follows:

- Each underlying fund is a diversified fund (e.g., mutual fund or exchange-traded fund).
- The TDF’s underlying funds have materially different risk-return characteristics.
- The TDF’s portfolio of underlying funds has risk-return characteristics that are “normally appropriate” for each age-based grouping of defaulted participants.
- The TDF’s portfolio of underlying funds tends to minimize, through diversification, the overall risk of a defaulted participant’s investment in such TDF.

In confirming that a TDF’s portfolio has “normally appropriate” risk-return characteristics for the relevant age-based grouping of defaulted participants, the plan sponsor may wish to consider their risk tolerance, investment preferences and other related demographic information based on the sponsor’s overall knowledge and understanding of the employee base.

Monitoring the plan’s QDIA. Once a TDF series has been prudently evaluated and selected to serve as a plan’s QDIA, the plan sponsor must regularly monitor the TDF series to ensure that it remains a prudent QDIA selection. Since a plan’s defaulted participants may not be actively monitoring their QDIA investments, the plan sponsor should be especially diligent in conducting its ongoing fiduciary reviews of the plan’s QDIA. When monitoring the plan’s QDIA, the plan sponsor should gather investment-related information as well as information concerning the level of QDIA utilization and the type of participants who are being defaulted into the QDIA.
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