

Black Box Network Services' Alan Perry

# Giving Participants a Simple Solution

## The Second Generation of Target-Date Retirement Funds



Plan sponsors are adding target-date retirement funds to their plans at an increasingly rapid pace. Why? Because these funds offer a single, simple investment choice for participants that provides diversification, professional management, and ongoing rebalancing. What could be better? The second generation of target-date retirement funds takes it up a notch, featuring open architecture and low cost. These are defining characteristics of the Schwab Managed Retirement Trust Funds, and plan sponsors are responding. *PLANSPONSOR* examined the present trend toward target-date funds with two plan sponsors: Fay Dautrich, senior vice president and director, benefits and payroll, of Sovereign Bank, based in Wyomissing, Pennsylvania; and Alan Perry, vice president, human resources, of Minnetonka, Minnesota-based Black Box Network Services. Sovereign's 401(k) plan has \$290 million in assets, and the Black Box plan has \$80 million in assets. Also interviewed were Jim McCool, senior vice president of Schwab Corporate and Retirement Services, and John Sturiale, field vice president, retirement investment services at Schwab.



**PS:** What was the decisionmaking process that led you to target-date funds?

**Dautrich:** In Sovereign's plan, we offer two different investment strategies to our participants: a professionally managed solution and an employee-managed solution. The employee-managed solution is for participants who want to make their own investment choices and, there, the opportunity exists to select from 10 diverse investment options representing each asset class. Alternatively, the professionally managed solution features a set of target-date retirement funds. In our view, this is a suitable strategy for those participants who—whether they are less investment-savvy, lack the time to manage their investments actively, or are simply uncomfortable with making investment decisions—prefer the professionally managed route.

**Perry:** Our philosophy at Black Box has been to provide discrete categories of funds; we have been wary of inundating our participants with too many choices. An important category from our standpoint was to offer pre-mixed, dynamic funds that changed as participants' own needs changed. We feel target-date funds are a necessary, competitive component in our 401(k) plan, and the challenge was identifying the best-in-class of those funds. That became even more important when, with auto-enrollment, we began

to use these funds as defaults for new hires.

**PS:** Is the experience at Black Box a representative one—plan sponsors are moving from the recognition that they need target-date funds to coming to terms with what are the best solutions in the space?

**McCool:** Plan sponsors in large numbers have recognized the fallacy of continuing to inundate participants with “over-choice” and, increasingly, plan sponsors are turning to target-date funds. However, it is important to understand that these are not just the latest bells and whistles—they are fundamentally important to the architecture of today's defined contribution plans. They are simple, appropriate, and professionally managed solutions, and they make sense for many participants. However, they require careful evaluation by the plan sponsor as to what types of target retirement funds to select, how they are placed structurally into plan menus, and how they are communicated to participants. These factors become even more important when you use these funds as defaults.

**PS:** When did Black Box begin auto-enrollment?

**Perry:** We have had automatic enrollment in place since 1997 but, until a year ago, we were defaulting participants into a stable value option. Historically, that was

the common wisdom: It was safe, it was secure, and our 401(k) committee felt we were doing the responsible thing as fiduciaries. However, the more we looked into it with both Schwab and our outside consultant, the more we began to believe that we could do better for our participants, because their behavior indicated that they stayed in the default option despite our best educational efforts on diversification. We essentially wanted to leverage the natural inertia of participant behavior to the advantage of the individual. So, we changed to defaulting into the suitable retirement-date options and, after a year's experience, we've had no second thoughts and no employee push-back.

**Dautrich:** Given the turnover rate in the early months of employment that is characteristic of the financial services industry, we don't have auto-enrollment in the Sovereign plan, so that type of default is not an issue for us. However, in January of this year, we adopted the Schwab Managed Retirement Trust Funds as our default investment vehicle for participants who don't make an affirmative investment election—prior to this, participants were defaulted into a stable value fund. In addition, we've been in an acquisition mode and, when we transition assets of acquired plans, the inclusion of target funds in our plan's investment structure improves our ability to accomplish a plan-to-plan transfer to similar investment

options—particularly with the increasing popularity of target funds.

**PS:** Do you map into like funds or, as some plan sponsors are doing now, do you just simply map the new participants into the suitable target-date retirement fund?

**Dautrich:** We map into like funds, but we see more and more assets in target funds, so the flows into these funds can be considerable.



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**—Alan Perry**

**McCool:** This is the next frontier. I believe we will see an increasing trend in situations like acquisitions, where participants will be defaulted into target-date funds with the option to make alternative investment elections on their own if they choose. At Schwab, we already have made the investment to build the systems to do that automatically. This is a win-win situation for employers and employees.

**Sturiale:** All too often, we see missed opportunities for sponsors to help their employees. Mapping employees’ retirement plan balances to similar investment options, say a stable value fund, can simply prolong a diversification problem. The employees may never move out of that stable value fund. Inertia is their worst enemy in this case. They need to be better diversified, and a sponsor can harness inertia to work in employees’ favor by automatically invest-

ing them in an age-appropriate target-date fund. There is no question that mapping employees into such funds really can be an optimal solution.

**PS:** The growing importance of target funds in these line-ups makes the selection of these funds more important than ever. Can you take us through the decisionmaking process you went through at Sovereign?

**Dautrich:** We had another target-date fund family in place since 2003; however, it was put on watch by our consultant through our ongoing monitoring process due to some shifts in investment strategy and performance concerns. On the recommendation of our third-party consultant, we decided to complete a full search for a replacement fund family, with Schwab surfacing as a finalist and then the successful bidder. What we liked in particular about the Schwab target funds was their structure—we felt the fact that they were nonproprietary was

important, as that gives Schwab the flexibility to change the underlying subadvisors when performance or organizational issues manifest themselves—and their historically strong performance.

**PS:** Of course, that sort of open architecture is not yet the norm in target-date funds.

**McCool:** That’s right, but Schwab has built its success by doing things that were vastly different from the norm. In the 401(k) industry, we have been at the very leading edge of the trend to enable sponsors and their advisors to pick the best fund line-ups for their plans, line-ups without proprietary fund requirements. That open architecture philosophy has since become the standard, except when it comes to target-date funds. Today, as we look at the development of the Schwab Managed Retirement Trust Funds, it is perfectly consistent for us to continue



advancing the message of open architecture, but this time within the concept of a professionally managed fund. Once again, this is a far different model than the norm, and enables employers to evaluate and select a managed retirement fund family composed of independent, industry-leading money managers in *each* asset class. We can offer these funds not only to the plans we record-keep, but also to any outside plan that believes an open architecture approach is consistent with its goals and in the best interest of its participants.

**Sturiale:** From an investment standpoint, when we first looked at what was out there four years ago in the target-date retirement fund space, we weren’t comfortable with the proprietary options that we saw, and we didn’t see how our clients could be either. What we set out to do was what plan sponsors would do if they had the time and relationships and wherewithal to put together these funds and manage them on an ongoing basis. We feel we bring the same fiduciary and institutional bent to this process. Just like a plan sponsor, we have no allegiance to any particular managers. If they perform according to the benchmarks we set up for them, they stay in the fund—no more, no less. Proprietary target funds are going to be run differently, almost by definition. I’ve never known one to terminate its own managers. In addition, just like a plan sponsor, we are acutely aware of portfolio overlap; there is no point in hiring two managers who think alike. Again, that’s an ongoing hazard you face with managers in the same fund family inside a target-date fund.

**PS:** Many of the target-date funds out there are mutual funds; the five Schwab Managed Retirement Trust Funds you offer—2010, 2020, 2030, 2040, and an income fund—are structured as collective trust funds. Why is that important?

**Sturiale:** There are several advantages. First, you can control the cash flows better, which can help performance. Second, you can keep the costs down—it's an institutional product, and all these cost savings can be passed to the plan and to participants. There's a third advantage, too, in that we can offer a stable value fund inside these target retirement funds—for those individuals close to retirement, having access to a fund that has similar returns but less volatility than a bond fund can be a real plus. It is also worth pointing out that, while there are cost savings, you are losing nothing in terms of efficiencies. These funds are traded through the National Securities Clearing Corporation just like mutual funds, so all the manual aspects of trading have been automated.

**McCool:** We are acutely aware of the fiduciary responsibility plan sponsors have with the choices they make for their plans. This is not a retail business. In an environment that is focused on cost, we believe the collective trust funds approach is a vital step toward creating a structure that has absolute minimum expenses associated with it. These are institutional products managed by The Charles Schwab Trust Company and built for qualified retirement plans, which allows the creation of transparent, low-cost, highly efficient, open-architecture funds. It's all about being able to demonstrate to clients exactly what they are paying for.

**Perry:** That was certainly part of our experience at Black Box. We also analyzed the first generation of lifestyle funds in our plan, and found them wanting both in terms of their structure and performance. When our consultants examined the Schwab approach, they told us that this was exactly the model that they themselves would have designed.



We're very confident about the cost-effectiveness of these managed solutions.

**Dautrich:** Schwab's fees are competitive for this product, and we believe that's in



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part a function of the collective trust structure. Our consultant is very comfortable with the Schwab approach.

**PS: Lifestyle funds of any description are notoriously hard to benchmark. Whose problem is that?**

**Sturiale:** It's our responsibility to benchmark appropriately, and we have to do what we can to help our plan sponsor clients in that regard. We create a benchmark with four components: the Russell 3000, which is the domestic equity portion; the MSCI EAFE, which is the international portion; the Lehman Brothers Aggregate, for bonds; and the three-month T-bill, the cash portion. Whatever point we are at on that curve—for example, the 2040 fund right now is 91% in equities—will reflect itself in the benchmark we use. We take a proactive approach in benchmarking and include this in our monthly fund monitoring reports. We make it very clear as to where we are vis-à-vis the benchmark at any time.

**Dautrich:** Benchmarking, as far as we are concerned, is critical. We need to know that the fund alternatives we are making available to our participants are performing, and

we need the right benchmarks to make that determination.

**Perry:** I agree, it is one of the complexities of target funds, and requires some analysis. We look to our own consultants in this regard, and any help that we can get from Schwab is important to us. These benchmarks can't be moving targets.

**PS: If the first generation of these funds had flaws, and this second generation deals with those flaws, is there a limit to the growth of target-date funds on retirement platforms?**

**McCool:** We introduced these funds in October of 2002, and we recently crossed the \$1 billion mark in assets. Target funds are clearly a necessary component in the trend toward

auto-everything in plans, and they're clearly going to become more than just another choice in an enlarging fund menu. I think growth is absolutely assured in general, as is the growth of nonproprietary approaches in particular. Plan sponsors are tackling more actively the inertia that thwarts so many participants' ability to get to a financially secure retirement, and target funds, when properly engineered, are showing stunning improvements for participants.

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