



**Defined Contribution**  
*Institutional Investment*  
*Association*

# Considerations for Implementing a Custom Target Date Approach: A Guide for Defined Contribution Plan Sponsors

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As target date funds gain in popularity with plan sponsors, participants and even the government (as evidenced by Qualified Default Investment Alternative (QDIA) guidance), they also gain additional scrutiny. While they offer a simplified solution to participants, they might not address specific needs of a plan. A one-size-fits-all solution may make investing easy, but it doesn't mean everyone has a perfect fit.

To address some of the concerns of the standardized target date products, many sponsors of large retirement plans are building their own target date funds. A custom series of funds, managed in a separate account structure, can be developed with a single defined contribution plan in mind. These funds can be more closely tailored to investment preferences, a company's investment policy statement, its benefits philosophy and unique employee demographics.

This is becoming a logical and widely accepted approach for many large plans. According to one survey,<sup>†</sup> by year-end 2010, 13% of large plan sponsors with target date funds anticipate using custom target date funds. Another survey<sup>††</sup> found 69% of respondents believe plan executives are highly likely or likely to offer customized funds if their plan exceeds \$500 million in assets. The survey showed that even at lower asset levels, plan sponsors are increasingly interested in building target date funds to suit their needs.

Even with the growing interest in a customized approach, it's important to first clearly understand what custom funds can offer, what it will mean in terms of cost and staff time, and then decide whether to implement them for your plan. This guide is designed to help plan sponsors understand the operational considerations when deciding to offer custom target date funds in a defined contribution plan.

## Standard Target Date Options vs. Custom Target Date Funds

As a plan sponsor, you have the ability to choose from a wide array of options when selecting a target date fund. A standard, collective or mutual fund target date fund solution, allows you to rely on processes controlled by the investment manager or fund administrator because these pools of commingled assets require strict governance and audit/oversight.

For example, both bank-maintained collective funds and mutual funds are required to undergo at least annual audits by a third party hired by the fund company or bank. Due diligence is conducted on each service provider (fund custodian, transfer agent, etc.). Investment guideline monitoring, adherence to valuation policies, and other critical tasks are monitored in scale by the fund companies offering collective and mutual funds.

You can choose from a suite of fund options which typically provide exposure to many of the equity, fixed income and money market asset classes that are available. Due to scale, fund families are able to provide competitive price ranges for their funds, which allow you to review and compare fees across various options and offer a suitable and economical set of target date funds for your participants.

In comparison, custom target date fund structures can provide more flexibility to tailor the portfolio. Typically, this approach is relevant for plans with greater than \$750 million in assets. Some industry experts put the threshold at \$1 billion.

<sup>†</sup> 2010 Survey of Large Plan Sponsors by Callan Associates.

<sup>††</sup> 2008 Defined Contribution Consulting Support and Trends Survey by Pacific Investment Management Co.

Custom target date options require separate accounts, since they are created only for a plan sponsor’s assets. This approach will also require more hands-on process management ranging from daily valuation to investment components and glide path management to oversight of the vendors who are doing the work. Because of the customized approach, a separate account target date fund can be managed very closely to align with newer investment strategies in the market (commodities, emerging markets, real estate, etc.) that may not be available to smaller plans.

In addition, the custom approach offers glide paths that can be tailored to meet the demographics of your company. An off-the-shelf product cannot meet these varying needs without additional communication and action by the participant, but you can structure your custom target date fund to more closely meet the needs of your workforce.

In both cases, most recordkeepers will have the ability to trade both standard and custom funds through existing data feeds to custodians or through the National Securities Clearing Corporation (NSCC) and similar platforms.

Both custom target date funds and off-the-shelf target date funds have their own set of considerations for use with a defined contribution plan. As a plan sponsor, you will need to adequately review items such as cost, oversight requirements, due diligence, and transparency to ensure that your plan participants have a target date fund option that helps accomplish participant retirement goals.

Off-the-shelf Target Date Funds (Mutual Funds or Collective Funds)	Custom Target Date Funds
Standard offering only	<ul style="list-style-type: none"> <li>• Custom to your plan’s needs</li> <li>• Can more closely match needs of your employee demographics</li> <li>• Can customize in relation to other retirement plans offered or benefits philosophy</li> </ul>
Investment managers often limited to one company	Ability to add new investment opportunities (such as inflation protected bonds or real estate)
Standard fees; typically imbedded in Net Asset Value	Fees are often a la carte for custody, investment management, consultant
Highly regulated for investor’s protection	Plan sponsor may have additional fiduciary oversight responsibilities
Typically no minimum investment	Typically offered only for larger plans; may not be feasible for smaller plans due to costs and resource availability
Frequently bundled with other services	Affords the sponsor control and choice for both investment and operational aspects of providing the suite of target date funds

## Investment Advisor Coordination

As you think about implementing a custom target date fund solution, the majority of plan sponsors will likely need to engage the consultant and advisor community for advice and comprehensive support. Many consultants and advisors have developed the capability to design and modify the initial and ongoing glide path, as well as an ability to help determine the number of target date strategies that should be offered, the array of underlying asset classes that should be employed and the time frame for rebalancing.

While the potential benefits of custom strategies are clear, the work required to create them often is not. You will need to think through operational decisions and participant communications and education (discussed in greater detail in subsequent sections), in addition to:

### Structuring, Developing and Monitoring Asset Allocation

By creating custom strategies you, as the plan sponsor, gain ultimate control in managing the glide path as well as the underlying core lineup. You are able to tap into investment options such as stable value and investment structures such as collective investment trusts (CITs) that are often not accessible within packaged mutual funds. In an effort to enhance diversification and reduce volatility, you may decide to add diversifying assets such as commodities, real estate or even less liquid alternatives into the custom strategies.

Consultants and advisors can help you determine the number of strategies that your plan may want to offer, the sufficiency and appropriateness of core investments, the initial and ongoing asset allocation or glide path and the rebalancing time frames. Most plan sponsors will want assistance determining the shape and objective of the asset allocation glide path. You may employ the consultant or advisor to act as a fiduciary, or even as a discretionary investment manager.

### Cost Implications

Investment consultants and advisors believe many plans can reduce expenses by creating custom target date strategies using the plans' own institutional core strategies for defined benefit plans. Consultants and advisors and plan sponsors have estimated the net savings, especially for larger plans, to be between

20% and 65% relative to using packaged target date funds. However, each plan is different. You will need to conduct a full analysis of your plan's costs, taking into account fees for consulting, recordkeeping, trustee services, custody, communications, legal support and the cost of staff dedicated to the project.

You should also consider whether you want to encourage plan participants to remain invested in the plan even after termination or at retirement, which may result in significant additional assets, and in turn, can reduce the overall plan cost.

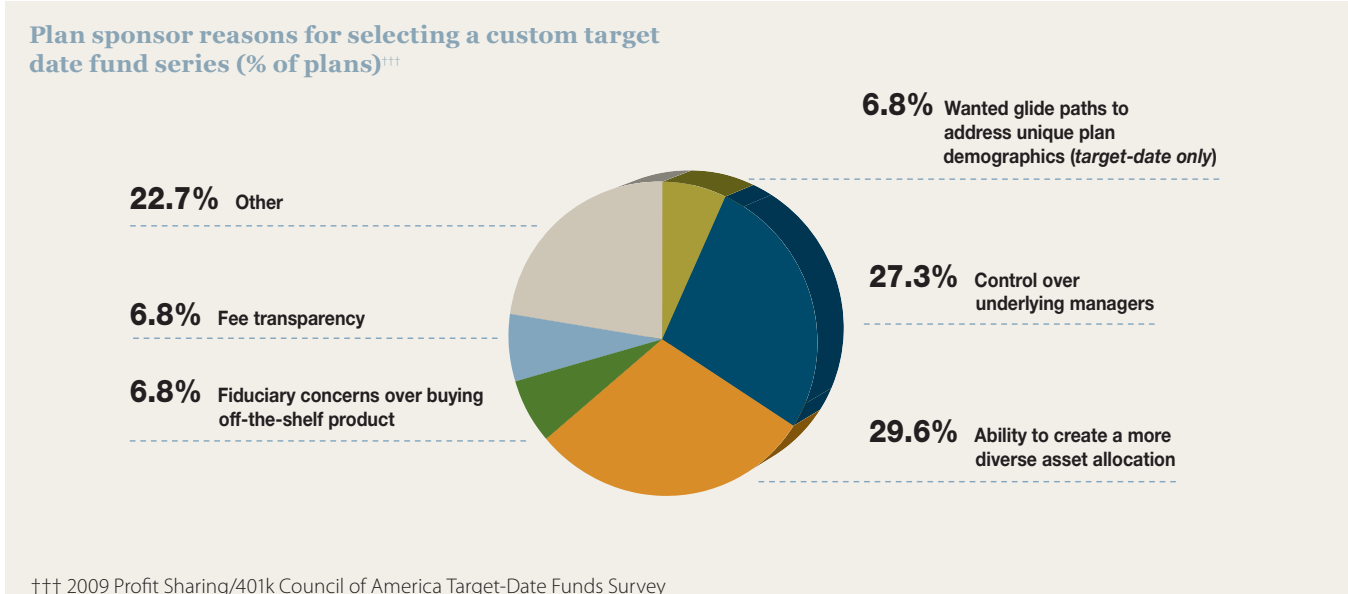
### Legal Issues

As with other plan investment options, custom target date strategies require legal support to ensure regulatory, fiduciary and structural considerations are met. In addition to ensuring compliance with plan guidelines and the law, specialized legal professionals may need to review the implications of regulatory requirements and safe harbor rules for asset allocation, and review plan documents.

If you plan to offer a custom target date option as a QDIA, determine if you, as a plan sponsor, will be the fiduciary on the asset allocation or if you want to hire a third-party fiduciary manager.

Discuss the fiduciary roles associated with custom target date funds with your consultant and legal professional.

If you are interested in developing a custom target date strategy, you do not have to go it alone. A range of services from investment managers to consultants and advisors are available, and you can choose the exact degree of third-party services that are needed to complement your in-house capabilities.



## An Operational Discussion

Custom target date strategies are relatively straightforward to set up from an administrative perspective. These strategies employ a similar approach as multi-manager institutional core strategies, which have been supported by recordkeepers and trustees for decades. There are two basic ways in which target date strategies can be set up:

### Model Portfolio Approach

A recordkeeping system solution where the plan administrator creates a set of model target date portfolios using all or a portion of the core funds. Typically, the underlying core funds will be shown at the participant-account level. The model portfolios will then dictate the asset allocation across the core funds. This approach limits you to only considering core funds.

### Trust Unitization Approach

A trust *and* recordkeeping system solution where each target date portfolio is set up as a separate account within the trust and as an individual investment option on the recordkeeping system, using all or a portion of the core funds. This approach also offers the option to include investment strategies outside of the core fund lineup.

The trust unitization approach requires that a custodian establish trust accounts for the portfolios/investment holdings. This can range from a single trust account that holds units of collective and mutual funds to a master trust arrangement with individual securities being managed by outside money managers. To allow for daily trading on the recordkeeping system, the custodian creates a Net Asset Value (NAV) for each custom target date fund. This is similar to a NAV from a mutual fund or collective fund, but specific to the customized portfolio.

Some recordkeeping providers offer a combination of these two approaches where, for example, the investment and rebalancing tasks normally provided by the trust are performed by the recordkeeper. Exploring recordkeeper approaches is an important step in designing custom target date strategies. Let's look at the trust unitization approach in more detail.

## Net Asset Value Calculation Process (Typical Timing and Methodology)

The steps in the process of building a unitized price are as follows:

### ▶ Process Participant Activity

Daily participant cash and unit transaction are delivered to the custodian from the recordkeeper in the early morning (typically before 6:00 a.m. E.T.) via electronic feed. The custodian processes the activity into the trust accounting system based on the category detail provided by the recordkeeper. The report also includes beginning participant units and ending participant units.

### ▶ Process Trades

The recordkeeper places all mutual fund/commingled trades with the appropriate investment managers within their respective deadlines.

The custodian posts daily mutual fund/commingled trades to the trust accounting system based on the electronic report provided by the recordkeeper. The custodian divides each fund's aggregate cash flow on the report by the prior night's price to calculate the total share amount to be posted to the accounting system.

### ▶ Reconcile Cash

The custodian moves daily cash flows based on the report provided by the recordkeeper and settles all associated trades with investment managers. The custodian then initiates all necessary wires and receives any incoming wires as directed by the reported activity.

### ▶ Process Expenses

The custodian posts daily expense accruals to the accounting system based on accrual estimates as directed and agreed upon by the client. This accrual approach ensures that fees are appropriately allocated to participant balances. Expenses may be for investment management or other plan support services. You, as plan sponsor, must authorize payment of all invoices to be charged against the accrued expenses within the trust.

### Reconcile Share Balances

▶ The custodian reconciles mutual fund/commingled share balances on a daily basis with each investment manager. Share positions for separately managed accounts may be reconciled less frequently than daily, but still would be reconciled at least once a week.

### Definitions

**Custodian:** The organization charged with settling, holding, administering and valuing assets on behalf of the defined contribution plan. This entity may also act as the trustee.

**NAV:** "Net Asset Value" or the price of a fund. NAVs may be referred to as "unit values" and are most frequently determined by the custodian bank.

**Recordkeeper:** The organization that is responsible for direct participant customer service, the interface used by participants, tracking holdings within individual participant accounts and other administrative tasks.

**Total Market Value:** This is the value of all holdings within a fund.

### ▶ Process Income

The custodian will accrue income – where appropriate – for income-producing securities. Dividends will be accrued on ex-date and held as a receivable until the dividend is received. Both of these accruals affect the NAV.

### ▶ Price Holdings

All holdings are valued by the custodian via the pricing service that entity utilizes. Custodians typically receive daily vendor feeds into the trust accounting system, which are then applied to current share positions to calculate total market value by fund.

### ▶ Calculate Unit Value

Once total market value is calculated, the custodian adds assets (cash, open sells, interest) and subtracts liabilities (open buys, accrued expenses) to get net cash. Next, net cash is added to current market value to calculate total net assets. The total net assets are then divided by the number of outstanding participant units for the unit value per share.

Assets – Liabilities = Net Cash

Net Cash + Current Market Value = Total Net Assets

Total Net Assets / Outstanding Participant Units = Unit Value per share

▶ **Rate of Return**

The custodian performs a daily rate of return review in which the current day unit value performance is compared to that fund’s underlying asset performance (commingled/mutual fund).

$$\frac{(\text{Current Day Unit Value} - \text{Prior Day Unit Value})}{\text{Prior Day Unit Value}} = \text{Unit Value Return}$$

$$\frac{(\text{Current Day Price for Underlying Asset} - \text{Prior Day Price for Underlying Asset})}{\text{Prior Day Underlying Asset Price}} = \text{Return on Underlying Asset}$$

Unit Value Return vs. Underlying Asset Return

Unit value returns are compared to a benchmark (as agreed to by the plan sponsor) for those funds that have separately managed underlying assets.

▶ **Final Audit**

The custodian performs a final review of the current day’s valuation. The unit value calculations and rate of returns are reviewed and signed off by a team leader/ auditor before the final prices are delivered to the recordkeeper.

▶ **Deliver Unit Values**

The custodian delivers final prices through an electronic feed to the recordkeeper typically by 7:30 p.m. E.T. In the case where prices may be delivered after this deadline, the custodian must notify the recordkeeper via telephone and continue to provide updates until prices are delivered. Upon receipt of the prices, the recordkeeper confirms and verifies receipt.

▶ **Price Adjustments**

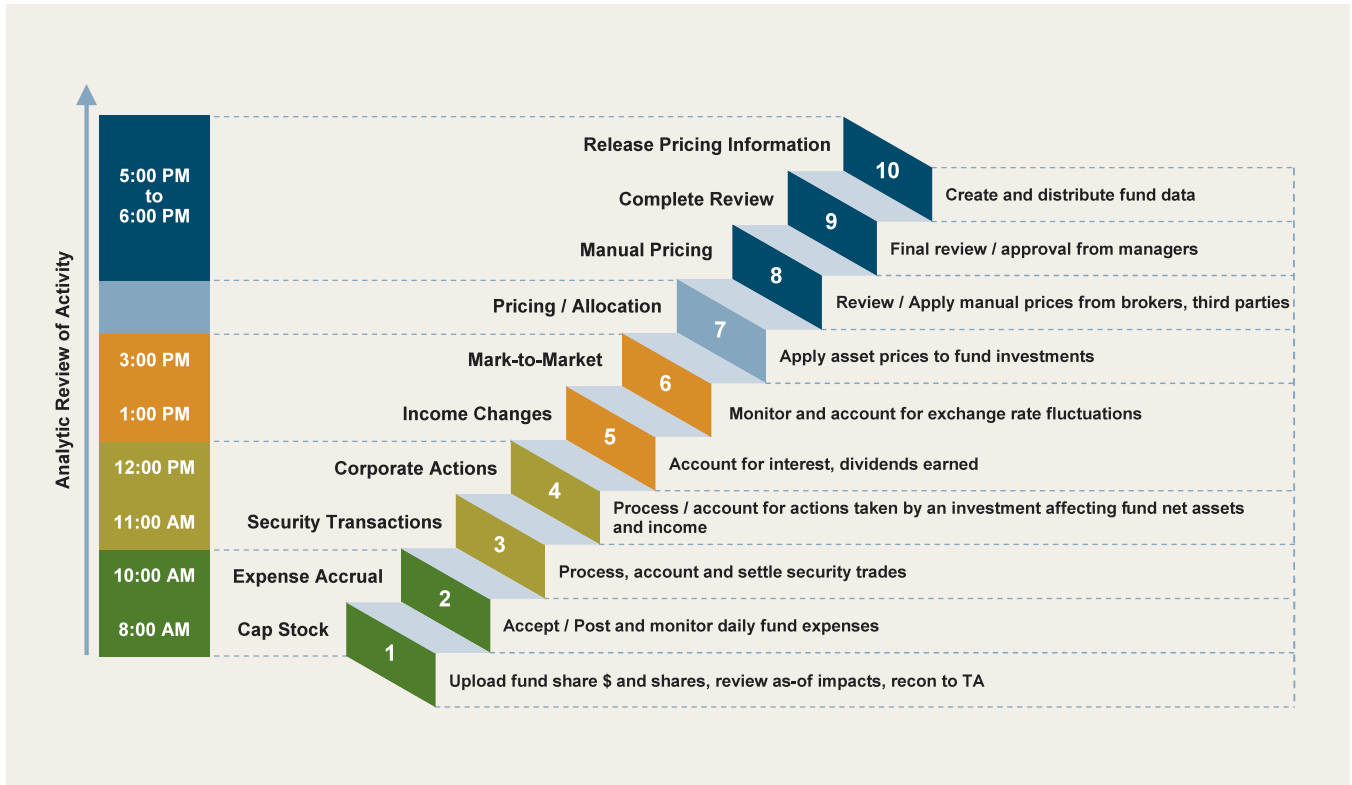
Occasionally, prices for underlying securities are changed or reissued. You should discuss how such adjustments will be handled for your plan, including who is responsible for recalculating the NAV, reprocessing participant balances on the recordkeeping system and potentially communicating such changes to participants. It’s important to consider timing, materiality and associated costs.

In the rare occasion where an inaccurate NAV is calculated, the recordkeeper and the custodian rely on pre-established tolerances and procedures to address the issue. The service provider will work with you to develop a level of materiality. Most plan sponsors agree to materiality guidelines of 10-50 basis points on the market value of the fund. Traditionally there can be a secondary tier at a participant level.



Pricing contingency procedures are all documented and agreed to by you prior to the initiation of service. The custodian exhausts all sources to retrieve a value including the investment manager. Typically when new pricing is not available, the custodian defaults an investments price to the last known value. The documented procedures include not only a contingency procedure but an escalation procedure as well so it will be defined when and who is to be notified of such issues.

Please refer to the following table for a sample daily process flow within the context of a daily valued defined contribution plan.



## Trading Protocol

The recordkeeper is responsible for trading with the investment managers for the investment options and core accounts based on participant activity. This recordkeeper information is transmitted to the custodian in order for the trust to settle the transactions with the investment managers. Controls are in place to ensure that these activities are processed correctly.

## Rebalancing

One of the key benefits of target date funds is the consistent oversight on asset allocation. The timing and methodology used to balance the portfolio is critical. You should discuss and document who has responsibility for rebalancing, the frequency as well as process. For example, will you use contributions/cash inflows for rebalancing, will you set a minimum dollar threshold before rebalancing, who will monitor the balances and notify impacted investment managers?

# Communicating Custom Target Date Funds to Participants

You recognize the value that custom target date funds offer to participants. Now you need to get this information to them. How?

## Start Simple

For your participants, start with the basics. Custom target date funds, like any target date investment, are designed to provide a simple approach to investing. This approach should appeal to your employee population with limited investment knowledge. Demonstrating this simplicity is a primary goal when you communicate to participants.

For starters, participants need to know it's important to have a diversified investment strategy, and they should find a risk level (and potential return) that's right for their age or time horizon. To help them get there, you can offer two investment approaches:

Automatic/Simple Solution	Mix-Your-Own Solution
<p>Custom target date funds create a "one-stop-shop" for investing. It is a <i>strategy</i> developed by investment professionals using a mix of funds designed for an individual with a specific range of years until retirement.</p>	<p>Core funds provide an opportunity to create a mix of investments that is unique to an individual's needs. This approach should be used if a participant has the desire and knowledge to create and manage an investment mix or is working with an investment professional to design an investment strategy.</p>

Helping participants understand which approach best meets their needs is the first step in communicating custom target date funds. Once they conclude that the simple, custom target date fund approach is right for them, they need to understand a bit more about how it works.

The custom target date fund is a strategy, not a separate fund with different investments. When you focus participants on the choice between automatic/simple solutions and mix-your-own solutions, you focus them on the full context of their decision – removing all other considerations such as understanding what's in the fund or understanding the details of how the performance of an asset class within the target date fund compares to a similar asset class in the core fund lineup.

## Key Participant Points for Custom Target Date Funds

Participants who choose to invest in custom target date funds (or those who default into them) need to understand what it means. Participants should understand that:

- While custom target date funds are monitored and managed by investment professionals, the funds still have risk and the value can go up or down depending on the market. A key point for participants to understand is that custom target date funds are designed to have an appropriate risk level, given a time horizon until retirement.
- The glide path is an important aspect of custom target date funds.
- Participants need to periodically assess whether this approach (custom target date fund) is right for them or if they need to take a different approach. This may be especially true as they approach retirement and begin to understand how and when they will need to draw on their retirement savings.
- Additional investment management fees are included in custom target date fund fees to cover the cost of investment professionals who create the mix of investments and monitor and adjust that mix over time.

## Getting to the Details

Custom target date funds provide participants with a solution to the investment dilemma that many individuals face. Yet, it's important to make sure participants can access details about the fund.

With a regular mutual fund, you may have a prospectus or fact sheets provided by the mutual fund company. With custom target date funds, you might not have those resources readily available, but they are not hard to create. You can outline the details of the custom target date funds in a fund overview page that:

- 1) Communicates the strategy and objectives.
- 2) Focuses on the asset allocation and shows how the custom target date funds are made up of the plan's core funds. Then, you can direct participants to the core fund details pages for more information.
- 3) Provides sense of risk level.
- 4) Discloses the fees associated with the funds (including any additional investment management fees).
- 5) And, explains how the asset allocation is expected to change over time (the glide path).

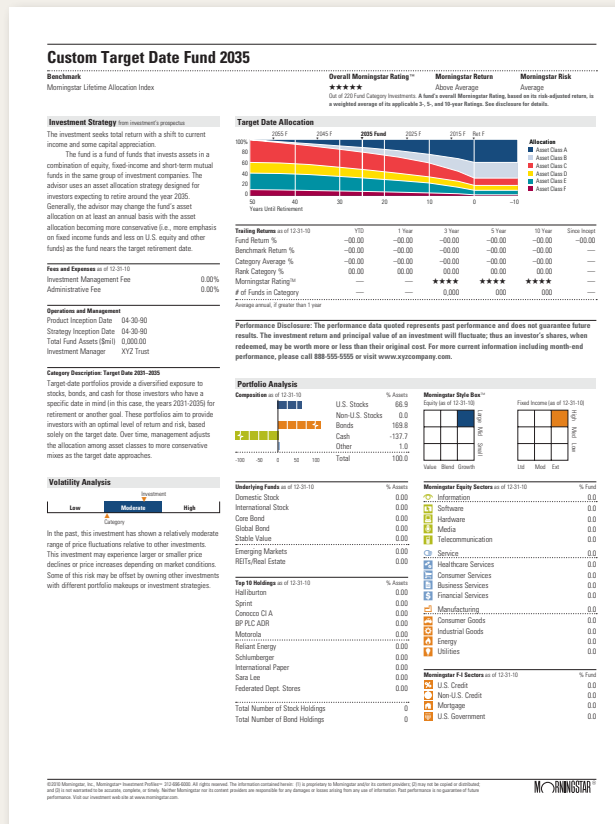
**Remember:** If you are adding extra investment sleeves with new managers or styles into custom target date funds that are not available in your core fund lineup, you'll need to make that detail available as well.

## Visualizing the Glide path

A valuable aspect of custom target date funds is the fact that an investment professional will create and monitor a glide path. As the fund gets closer to the target date, the asset allocation in the custom target date fund will change, gradually becoming more conservative. It's important to help participants understand how the glide path works and that it means a participant's risk will change over time. A compelling visual of the glide path can also help employees see and grasp this concept.

## Sample Fund Fact Sheet

There are many ways that you can put fund overview pages together for custom target date funds, below is one example.



## Summary

Custom target date funds can be an effective investment approach for participants in terms of offering diversification and active asset allocation. As plan sponsors consider the possibility of creating custom target date fund options, understanding the operational and recordkeeping implications is important. Off-the-shelf target date funds are also effective options to consider if you decide custom is not the right approach at this time. This guide is intended to provide background information and context for consideration. You should always review your own plan and requirements with your legal, tax, investment and other appropriate consultants.

Here’s a summary checklist of key activities and decisions. This list is not meant to be exhaustive, but a starting point for you as you consider a custom target date strategy.

Investment structure	Operational structure	Fees	Communications
<ul style="list-style-type: none"> <li>• Determine initial and ongoing glide paths</li> <li>• Determine rebalancing timeline and procedures</li> <li>• Choose underlying investment strategies/vehicles</li> <li>• Designate discretionary asset manager/fiduciary</li> <li>• Review any trading restrictions with underlying assets/funds</li> <li>• Conduct ongoing monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• Engage custodian, trustee and recordkeeper</li> <li>• Determine timing and process for NAV calculation</li> <li>• Establish cash/liquidity thresholds</li> <li>• Document trading protocol including cutoffs, communications</li> <li>• Determine process for correcting pricing/trading errors</li> </ul>	<ul style="list-style-type: none"> <li>• Inventory all applicable fees</li> <li>• Determine timing/accrual process for fees</li> <li>• Document approval process for applicable fees</li> </ul>	<ul style="list-style-type: none"> <li>• Determine benchmarks to be used</li> <li>• Document who will calculate and communicate performance</li> <li>• Monitor frequency of updates, considering all avenues used by your plan: web, call center, voice response unit, print</li> <li>• Determine who is responsible for preparing fact sheets</li> <li>• Communicate protocol for changes to underlying assets or glide path</li> <li>• Communicate related fees</li> </ul>

## About DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a non-profit association dedicated to enhancing the retirement security of American workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

### **DCIIA's mission is underpinned by five core beliefs:**

- The primary role of defined contribution retirement plans is to create retirement income adequacy: Helping plan participants build sufficient savings to achieve their goals while working (accumulation) supports their income needs in retirement (distribution).
- Well-designed default programs can improve retirement outcomes: Auto enrollment and auto-escalation (of participant contribution levels), when combined with default investment options that take advantage of institutional asset management techniques, help increase savings levels and promote better retirement outcomes.
- The regulatory framework and industry infrastructure must offer full support for all types of institutional investment approaches and products, giving defined contribution plans access to the complete toolkit of investment, retirement income and advice solutions.
- Plan sponsors and their consultants should have the ability to select the best combination of partners to meet plan needs, including investment and retirement solutions, record keeper, custodian, managed account, advice and other service providers.
- Full transparency on pricing and revenue sharing is critical for plan sponsors to evaluate the optimal combination of solutions to deliver improved retirement outcomes for their participants.

### **To further its mission, DCIIA:**

- Aims to make it simpler for defined contribution plan sponsors to implement appropriate institutional investment management approaches in DC plans focused on delivering higher returns and reduced risks;
- Provides an independent forum for thought leadership on advancing defined contribution and retirement income design, including institutional default investment strategies and retirement income solutions;
- Conducts research, publish analysis and insights and host events that support the advancement of institutional approaches and better defined contribution design;
- Identifies and removes barriers for plan sponsors so that they may pursue improved defined contribution institutional investment structures;
- Encourages improved fiduciary practices and tools to support institutional defined contribution plan design; and
- Educates legislators and regulators about issues and challenges in institutional defined contribution plan design and better approaches to retirement security.