Whatâ€™s Next for QDIA?

When President George W. Bush signed the Pension Protection Act of 2006 (PPA) into law, its primary intent was to shore up the U.S. pension system by making defined benefit plan sponsors more accountable for plan funding. However, PPA also included a number of other changes that ushered in a new framework for defined contribution plans and participants.

Prior to PPA’s passage, requiring workers to make proactive choices about enrolling in their employer’s retirement plan was the norm. It was also normal to require them to make their own investment decisions. While plan features such as automatic enrollment and automatic contribution increases existed prior to enactment of PPA, plan sponsors were mostly hesitant to use them.

PPA created a path to plan sponsor safe harbor for these features. It also created the qualified default investment alternative (QDIA), which allowed plan sponsors to invest participants in risk- and age-based investment options, like target-date funds, when they do not make their own choices. Previously, plan sponsors primarily defaulted participants who didn’t make investment elections into stable value or money market funds.

“PPA was seen as a triumph of behavioral finance that would harness workers’ inertia to both get them into defined contribution plans and get them invested appropriately for the long term,” says CAPTRUST Defined Contribution Practice Leader Jennifer Doss. “Combined with automatic contribution increases, this new framework put many Americans on a path toward retirement security.”

The Rise of Target-Date Funds

While target-date funds had been around—and had been on plan investment menus—for more than a decade at that point, they had not yet caught fire. PPA—specifically, the legitimization of automatic enrollment and creation of the QDIA—provided a boost that drove mainstream adoption. These age-based asset allocation funds quickly became the QDIA of choice for many plans as PPA's requirements went into effect.

At the time, the nascent target-date fund market was dominated by five providers—Wells Fargo/BGI, Fidelity, T. Rowe Price, Vanguard, and Principal. But it didn't take long for other asset managers to jump into the fray, kicking off a burst of innovation, as they sought to differentiate themselves in a rapidly crowding market.

Some asset managers differentiated via the use of active, passive, or a combination of underlying funds, volatility management tools, or addition of diversifying asset classes. Some differentiated via their *glidepaths*—their changing asset allocations over time—sparking a debate about the superiority of to- versus through-retirement funds. Still others developed collective investment trust (CIT) products and custom target-date programs.

Today, the Plan Sponsor Council of America's *64th Annual Survey of Profit Sharing and 401(k) Plans* reports that 85 percent of plans have a QDIA, and more than 86 percent of plans that have a QDIA use target-date funds as their default investment option.

Further, according to the same survey, among plans that offer target-date funds, 50.5 percent of plans use actively managed target-date funds, 34.4 percent use passively managed, and 15.3 percent are a mix of the two. More than 40 percent of plans are using target-date funds made up of non-proprietary funds (funds not managed by their recordkeepers), 30.6 percent are using a mix of proprietary and non-proprietary funds, and 29 percent are using proprietary funds. About an even split, depending on plan size. In all, target-date funds represent almost 31 percent of plan assets.

"The initial post-PPA exuberance about target-date funds has certainly cooled in recent years," says Scott Matheson, managing director and head of CAPTRUST's Institutional Group. "The market seems to have achieved something of a steady state, with significant assets flowing into target-date funds, despite a slowdown in innovation."

A few nuggets from Morningstar's 2022 "Target-Date Strategy Landscape":

- Target-date strategy assets grew to $3.27 trillion as of the end of 2021, up from $2.8 trillion at the end of the prior year.
- CIT-based strategies saw 86 percent of net inflows last year and will soon overtake mutual funds as the most popular vehicle.
- While the asset management leaderboard has changed since the early days of PPA, the market remains very concentrated, with the top five players commanding 80 percent of target-date fund assets.
- Investors have benefited from all this innovation and competition and are, on average, paying less. The average asset-weighted fee for target-date funds fell to 0.34 percent, down from 0.51 percent five years ago.

Target-Date Downsides

This data paints a rosy picture of target-date funds, and to be fair, overall, they are a good vehicle for those participants with less complicated financial situations. They do, however, have their drawbacks.

“Target-date funds are designed as standalone one-size-fits all investments; they assume that everyone of the same age has the same financial situation and risk tolerance,” says Doss.

In other words, a fund with a target date of 2035 is geared to a 52-year-old investor planning to retire in or near 2035. They assume that the investment needs of all 52-year-olds are the same when, in fact, some may have above or below average incomes, significant (or nonexistent) savings, or different risk tolerances.

Target-date funds typically use proprietary funds selected by the funds’ manager, which the plan sponsor has no control over. There is no opportunity to determine what asset classes are included or align the underlying managers with the plan’s core menu. This means that you may end up with some subpar funds in your plan and there’s not much you can do about it.

Lastly, some target-date fund providers do not manage their asset allocations after retirement age and, instead, maintain a static asset allocation from age 65 and up. This ignores the participant challenges of managing a retirement portfolio during retirement drawdown or decumulation.

What Next?

While target date innovation may have slowed down, interesting things are happening elsewhere in the world of QDIAs. Specifically, the rise of cost-effective, flexible managed account programs has the potential to disrupt the target date oligopoly and replace a good and convenient QDIA option with something much better in the coming years.

Managed accounts have, of course, been around for some time, available from the likes of Edelman Financial Engines, Morningstar, and others. According to Vanguard’s “How America Saves 2021” report, nearly 40 percent of all plans offered managed account advice in 2020, and more than seven in 10 larger plans offered the service. However, only 10 percent of plan participants take advantage of the offering.

There are two main reasons behind this meager uptake. First, “typically, managed account programs are bolted onto a plan and simply made available to participants,” says Matheson. “They are not widely promoted, nor understood.”

More importantly, despite their ability to be used as QDIA, only 3.7 percent of plans use them for that purpose despite, arguably, being a better product.

What’s the disconnect? “Many plan sponsors’ impressions of managed accounts are rooted in the past and don’t consider the current state of the art,” says Doss. Given plan sponsor inertia and the work involved in changing a plan’s default investment option, they may not seem so exciting. But managed accounts have been on their own evolutionary journey over the past two decades, and, over that time, they have become much more appealing—and worthy of consideration as a QDIA.

The first thing to note is that the next generation of QDIA is likely to be a hybrid of target-date funds for younger participants and managed accounts for older participants.

“The rationale being that younger people’s asset allocation should be more aggressive; they’ve got lots of time and human capital at that stage of their lives,” says Doss. From their 20s into the mid- to late 40s, a target-date fund may be perfectly appropriate for them.”

However, as they age, participants’ financial circumstances start to diverge. That’s when the managed account kicks in. Instead of using only age—or time until retirement—to drive asset allocation, the managed account can use a dozen or more data points to create much more personalized advice and portfolios. Data points such as salary, account balance, pension or other plan savings, savings rate, and sponsor match provide the basis for a much more personalized portfolio and are easily accessed via recordkeeping systems.

“That means that even defaulted and disengaged participants can receive personalized advice,” says Doss.

This personalized portfolio can take them the last leg of their journey to retirement and beyond. Along the way, they can engage by adding further information about their financial situation, such as outside assets, actual retirement age, expected income needs, and Social Security filing dates, for even more tailored advice that includes how to take withdrawals to fund their expenses on top of asset allocation.

“Even if they don’t engage, older participants will receive a much more bespoke experience,” says Matheson. And that’s important in today’s tight labor market. Employees are looking for something extra from their employers.”

“What’s nice about this hybrid QDIA approach, as we call it, is that it doesn’t require revolutionary change,” says Doss. “All the necessary parts are available and already in place for many plans. It’s really just a reframe of how they are being used.”

Of course, other due diligence boxes must be checked. The cost of the program from the early target-date fund years into retirement must be reasonable given the services provided along the way. Plan sponsors will want to understand the underlying investment methodologies—as they would when picking a target-date fund series.

They will also need to monitor the program over time, which will require a mindset shift from traditional investment benchmarks to an outcome orientation that focuses on retirement readiness.

“Longer term, this hybrid approach lays the tracks for further innovation that could, for example, include incorporating retirement income strategies or guaranteed income products like in-plan annuities,” says Doss. With more participants keeping their money in plans after they retire, services like this may become increasingly desirable.

While the jury is out on whether PPA had its desired effect on pension plans, the changes it brought to defined contribution plans have been game changing in several ways—higher participation, higher balances, and better investment options for defaulted participants. As importantly, it kicked off more than a decade of innovation that creates a lot of possibilities for plan sponsors. For many, it might be time to reassess their QDIA to see if the time is right for what’s next.