Fiduciary considerations: The qualified default investment alternative

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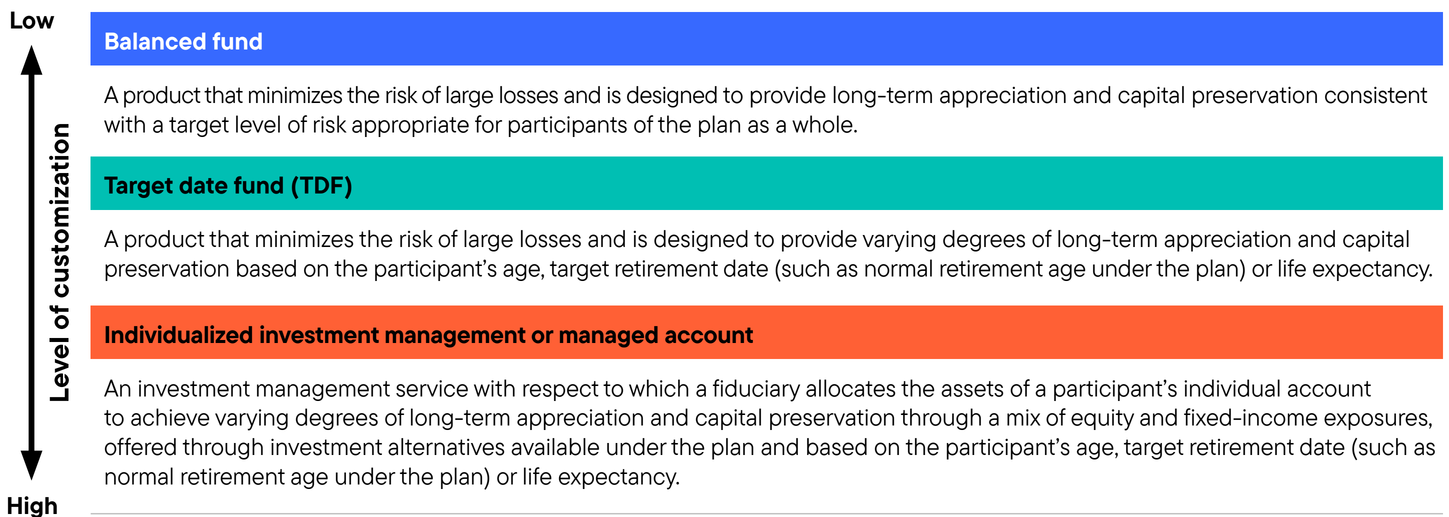
In this report,[1] we consider the differences between the types of qualified default investment alternatives (QDIAs) and relevant fiduciary considerations when selecting a QDIA for a retirement plan that is subject to the Employee Retirement Income Security Act of 1974 (ERISA).

Importance of default investments

In the absence of participant investment direction, contributions to a participant-directed retirement plan are automatically invested in a QDIA selected by a plan fiduciary. As participant-directed individual account retirement plans have become more popular, default investing has become increasingly important. In particular, over the past 15 years automatic enrollment in retirement plans has become very common as employers voluntarily opted for the feature as a matter of plan design. With automatic enrollment and automatic escalation of deferrals generally required for new 401(k) and 403(b) plans, default investments will become more important than ever.[2]

QDIA and fiduciary fundamentals

- **QDIA safe harbor:** ERISA provides a safe harbor—fiduciary liability relief—for automatic investments in a QDIA. The regulations under ERISA provide requirements that must be met to obtain such fiduciary relief and provide that in order to qualify as a QDIA, the investment alternative must constitute one of the following:[4]



- **Duties of prudence and loyalty:** The QDIA regulations under ERISA specify that plan fiduciaries are not relieved of their duties to prudently select and monitor QDIAs.[5] This means that when recommending, selecting and monitoring a QDIA, fiduciaries must undertake prudent decision-making processes and must not subordinate the interests of participants and beneficiaries—such as by sacrificing investment returns or taking on additional investment risk—to objectives unrelated to the provision of benefits under the plan.[6]

1. Franklin Templeton Institutional, LLC engaged Stradley Ronon to research and prepare this analysis, which is available for general distribution.
2. The SECURE 2.0 Act of 2022 (SECURE Act 2.0). The SECURE Act 2.0 mandates that a 401(k) plan or 403(b) plan that is newly established on or after Dec. 29, 2022 (a new plan) satisfy certain automatic enrollment and automatic escalation requirements starting with plan years that begin after Dec. 31, 2024. For plan years beginning after Dec. 31, 2024, a new plan must satisfy the automatic enrollment and automatic escalation requirements, which generally require that employees be automatically enrolled at a contribution percentage of at least 3%, but not more than 10% and contribution percentages must automatically increase by 1% on the first day of each plan year following the completion of a year of service until the contribution is at least 10%, but no more than 15%. The mandatory rules do not apply to 401(k) and 403(b) plans in existence before Dec. 29, 2022, nor do they apply to governmental plans, church plans or plans sponsored by new or small businesses. For more information, see: https://www.stradley.com/insights/publications/2023/01/employee-benefits-alert-january-9-2023
3. ERISA § 404(c)(5) and the regulations thereunder.
4. 29 C.F.R. § 2550.404c-5.8. *Id.*
5. *Id.* Additionally, the safe harbor does not provide relief from the prohibited transaction provisions of ERISA Section 406.
6. ERISA § 404(a) and the regulations thereunder.

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In general, this means that fiduciaries should have thoughtful, objective processes to determine whether a QDIA is reasonably designed to further the purposes of the plan, taking into consideration the risk and return associated with a QDIA compared with reasonably available alternatives.[7] Fiduciaries must consider factors that they have reasonably determined are relevant to a risk-and-return analysis.[8] Such factors may include risk, investment strategy, asset allocation, performance and fees and expenses.[9] In addition, when analyzing QDIA options, plan characteristics and demographics as well as participant behavior and needs can be important factors.[10]

QDIA market

TDFs are currently the most common QDIA among plans, though managed accounts are growing in popularity. Balanced funds are not as prevalent as are QDIAs, and, therefore, are not discussed herein.

- **TDFs:** Target date funds are typically comprised of multiple (sometimes dozens of) underlying investment funds, which carry their own fees and expenses. TDFs take into account *only* a participant's age or projected retirement date, and they adjust investments based on age/retirement date, usually shifting from more equities to more bonds as participants get closer to retirement. There is significant variety in TDF offerings, including with respect to fundamental characteristics such as investment strategy/style and asset allocation over time. For example, TDFs can be actively managed, passively managed or blended. Actively managed TDFs are typically comprised of actively managed investments with an objective to outperform broad market indexes, and as a result, they typically have higher fees and expenses. Passive TDFs are typically comprised of passively managed investments designed to achieve performance that is aligned with an index, like the S&P 500®, and as a result, they typically have lower fees and expenses. Hybrid or blended TDFs invest in both actively and passively managed investments. Plans may also construct custom TDFs using funds that are available on the plan's core investment menu. Additionally, TDFs may be designed to go "to" or "through" retirement. A to-retirement glide path will generally reach its most conservative allocation at the target retirement date and maintain the allocation for the duration of the retirement period. A through-retirement glide path will continue to adjust the asset allocation through the target retirement date, reaching its most-conservative allocation at some point past the retirement date.

- **Individualized investment management:** Individualized investment management services are provided by professional investment managers who have the knowledge and expertise to make informed, unconflicted investment decisions on behalf of participants. These services have the potential to be highly customized to meet the unique needs of each individual participant by using the investment options that are available on the plan's core investment menu, and therefore plan fiduciaries already have done due diligence reviews of the plans. This means that each participant's portfolio may be tailored to their individual needs by taking into account personal information (which may be provided by the employer), including, for example, age, target retirement date, income, deferral rates, gender, employment tenure, employer contributions, state of residence, plan loans, dependents and other employer-provided benefits like pensions, deferred compensation plans and company stock balances. To the extent that participants provide additional information, the services may be further customized by considering additional factors such as outside assets, risk tolerance, retirement goals, minimum retirement income levels, tax management and withdrawal strategies. Individualized investment management services include continuous monitoring and rebalancing to ensure that the investment strategy and portfolio remain aligned with the participant's individual circumstances, needs and desires.

Personalized advice leads to better outcomes for participants

Research shows that personalized investment advice can improve investment outcomes and increase savings rates.[11] Surveys suggest that plan participants who receive individualized investment advice save more for retirement and have more appropriate investment portfolios, which tend to outperform other possible investment options.[12] In addition, discretionary management of a participant's individual account provides additional fiduciary protection for participants. Moreover, participant demand for personalized investment advice and investment solutions is rising.[13] Accordingly, plan fiduciaries and plan sponsors are increasingly seeking ways to provide plan participants access to retirement savings education, financial wellness tools and personalized investment solutions.[14]

7. 29 C.F.R. § 2550.404a–1.
8. *Id.*
9. Target Date Retirement Funds–Tips for ERISA Plan Fiduciaries, U.S. Department of Labor Employee Benefits Security Administration, February 2013, https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf.
10. *Id.*
11. https://www.morningstar.com/lp/impact-of-managed-accounts-2022update.
12. https://corporate.vanguard.com/content/dam/corp/research/pdf/quantifying-the-investors-view-on-the-value-of-human-and-robo-advice.pdf; https://www.investpmc.com/sites/default/files/documents/PMC-CAP-SIGMA.pdf; https://www.morningstar.com/lp/impact-of-managed-accounts-2022update.
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Fiduciary considerations

It is important that fiduciaries follow and document a prudent decision-making process. As with any plan product or service, fiduciaries should conduct due diligence and consult with outside experts, as appropriate, when considering QDIA options for a plan. When selecting or replacing a QDIA, fiduciaries should:

Know the types of QDIA options that are available to the plan

TDFs are widely available, and managed account solutions are becoming more widely available. As an initial matter, fiduciaries should understand the array of QDIA options that are available to the plan. Fiduciaries can generally obtain this information from the plan's recordkeeper or investment adviser.

Understand the investment methodologies (e.g., strategies, styles, asset allocations and other investment factors) utilized by available QDIA options

It is important to understand whether the available TDF options are active, passive or blended and which glide path is used by each option. Similarly, it is important to understand the methodology used by managed account services as well as the number of allocations/portfolios available through the service. For example, some services might offer 15 different investment allocations while others may offer 50. Moreover, some managed account services might focus on passive funds to minimize investment expenses, while others might focus on actively managed funds to seek outperformance rather than a benchmark. It is also important to understand how personalization factors influence and impact the investment portfolio. Fiduciaries should consider how these factors and methodologies align with the plan's philosophies and objectives as well as with participants' abilities to meet their retirement needs.

Consider the performance of available QDIA options

It is important to understand one major difference between TDFs and managed accounts: While off-the-shelf TDFs are typically comprised of underlying funds that have not been analyzed by a plan's fiduciaries, managed account services typically use funds that are on the plan's investment menu and are continuously reviewed and monitored by the plan's fiduciaries. This provides fiduciaries a certain level of confidence and comfort with respect to the underlying funds utilized in a managed account service as compared with a TDF. Nevertheless, fiduciaries should review the performance of each available QDIA option against appropriate benchmarks. Benchmarks for TDFs might include peer group comparisons or custom benchmarks that include a mix of indexes reflecting the asset classes used in the glide path. The performance of managed account programs is inherently influenced by the investments offered on the plan's investment menu, and given the personalized nature of each portfolio, appropriate benchmarks and historical data will require customized analyses. Fiduciaries should work with their recordkeepers and investment advisers to ensure that they have the ability to track and review performance data on an ongoing basis.

Consider the extent to which individualized participant information is utilized by a QDIA

While TDFs take into account only a participant's age/retirement date, managed advice services typically take into account other individual factors. For plans with a disengaged participant base, it is particularly important to understand the information that a QDIA uses to manage a participant's assets in the absence of participant engagement. For example, managed advice services may consider factors beyond age, such as income, deferral rate, gender and dependents, which information may be provided by employers. Moreover, participants who wish to actively engage with the managed advice service should be able to easily and seamlessly interact with a managed advice program and provide personal information such as outside assets, risk tolerance and retirement goals. The more participant information the service has, the more personalized and valuable the investment management will be. Managed advice services should provide a user-friendly and intuitive interactive participant experience, as user experience is generally a key factor of value and an indicator of participant likelihood to engage and make full use of the service. Fiduciaries should feel free to ask managed advice service providers for demonstrations of their products.

Understand other services that may be available through each QDIA

To fully appreciate the value of each QDIA option, it is important to understand the entire array of services available in connection with each option. A TDF typically is a suite of funds that do not provide for participant interaction or any additional services apart from management of the investment fund. On the other hand, in addition to ongoing asset management, managed advice platforms may provide other services, such as general financial education, recommendations regarding deferral rates, information to help participants maximize available employer-matching contributions and ongoing participant outreach. Fiduciaries should consider the importance and value of such services to plan participants.

Consider the fees and expenses associated with each available QDIA option

Fiduciaries must consider the extent to which the fees associated with each available QDIA are reasonable in light of the totality of the services available. To appropriately compare available QDIA options, fiduciaries should work with their recordkeepers, investment advisers and other consultants to understand the competitive market rate at which each QDIA option is available to the plan. The analysis of the reasonableness of fees should be objective and take into account the totality of the services available through the product or service, including quality and quantity. In general, because of the difference in service levels, actively managed TDFs tend to cost more than passively managed TDFs, and managed accounts tend to cost more than TDFs. However, as technology advances, so does the ability to offer more services at a lower cost. Nevertheless, ERISA does not require that a fiduciary select the cheapest available option. Prudent decision-making may result in the selection of a product or service that has higher fees but provides greater value than a cheaper product or service.

CONCLUSION

The selection and monitoring of a plan's QDIA are very important. Employers that are concerned about their participants' retirement readiness should consider offering individualized managed advice services within their retirement plans, as personalized investment advice is shown to lead to increased savings rates and more appropriate investment portfolios for participants.

In addition, fiduciaries that are tasked with selecting and monitoring a plan's QDIA should consider which type of QDIA is appropriate for the plan in light of participant needs and other factors. Fiduciaries must consider the value of potential QDIA options. In particular, selecting a TDF as a plan's QDIA because it is the cheapest available option would be inconsistent with the ERISA fiduciary standard. Moreover, selecting a managed advice service that is more expensive than other available QDIA options, such as a TDF, would be consistent with the ERISA fiduciary standard when the managed advice service offers greater value.

All investments involve risk, including loss of principal.

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