

TOOL KIT: HOW TO SELECT A QDIA

BY SARAH PARKER, AIF®, SENIOR MANAGING DIRECTOR

The Department of Labor (DOL) created a regulatory safe harbor in 2007 to limit the liability of plan sponsors that invested employee contributions on behalf of employees into default investments. The safe harbor allowed plan sponsors to choose from three default investments – Qualified Default Investment Alternatives (“QDIA”) – that would qualify a plan for safe harbor protection. The following “Tool Kit” offers a summary of the QDIA options and key decision-making questions.

WHAT ARE THE OPTIONS?

The QDIA available under ERISA are:

- Life-cycle fund or Targeted-retirement-date fund;
- Balanced fund; or
- Professionally managed account

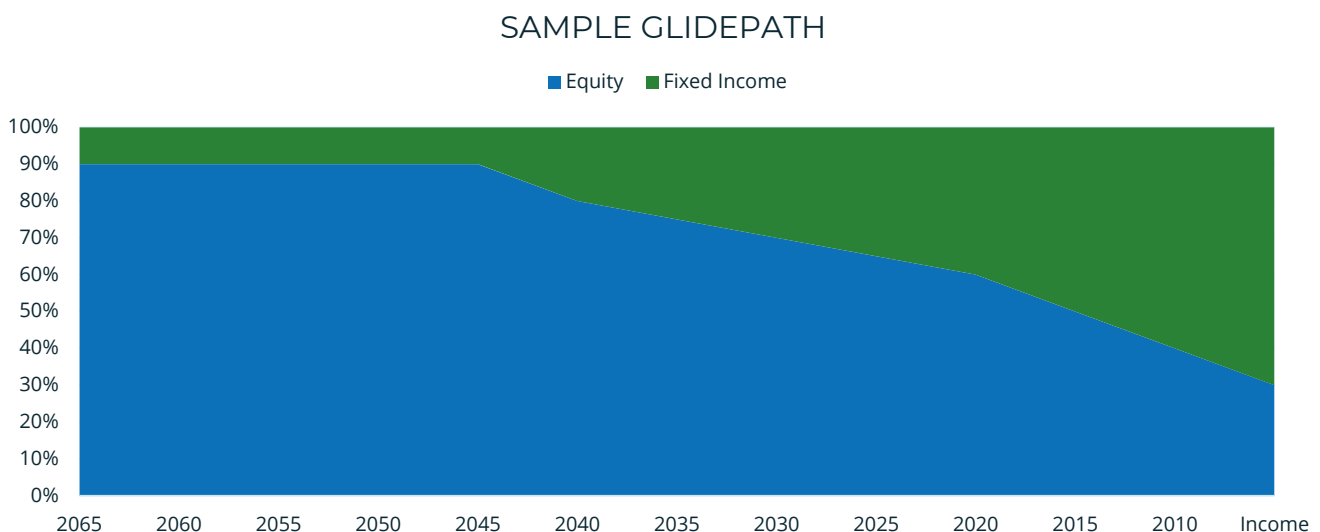


Below are definitions of each option and the advantages and disadvantages of using one as a QDIA option.

LIFE-CYCLE OR TARGETED-RETIREMENT DATE FUND - *Participants Defaulted by Age into Multiple Funds*

A life-cycle fund automatically adjusts the asset allocation mix to match a participant’s risk tolerance as he or she nears retirement. This usually means the allocation to fixed income increases over time as the equity allocation decreases. The “glide-path,” or the decline of equity exposure overtime, is predetermined by the investment managers alongside the underlying asset class exposure and investment vehicles. Funds are named with the anticipation of retirement year (e.g., ABC 2030 Fund). Underlying assumptions are accounted for on the design of the glide-path (e.g., age of retirement, length of retirement, withdrawal assumptions). Underneath the hood of each fund is a group of investment managers that usually consist of diversification across geographic locations, market caps, styles, sectors, and possibly management styles. The underlying management and weight are decided upon by the target date fund manager. A sample Target Date Glidepath is shown in Figure 1.

Figure 1



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LIFE-CYCLE OR TARGET DATE SUITES ADVANTAGES & DISADVANTAGES

DISADVANTAGES

- **Participant asset allocation determined by age only;** near-term retirees may require a more customized portfolio considering additional factors (e.g., additional sources of income, unique spending needs during retirement)

ADVANTAGES

- **Broad diversification in each fund**
- **Asset allocation changes occur overtime;** younger participants receive a significant equity allocation to protect against longevity risk
- **Aligns with peer selection;** over 80% of plan sponsors select a target date suite as the QDIA per the 63rd PSCA Plan Sponsor Survey

BALANCED FUND - *Participants Defaulted into One Fund*

A balanced fund is a mix of investments that considers the characteristics of the group of employees as a whole, rather than each individual participant. A balanced fund typically maintains a strategic asset allocation that is most commonly a 60% equity/40% fixed income portfolio. Manager groups underneath the hood of each fund may illustrate diversification similar to a life-cycle or target date fund; or a collection of individual stocks and bonds may be held.

BALANCED FUND ADVANTAGES & DISADVANTAGES

DISADVANTAGES

- **Static asset allocation;** participants would need to select alternative options as they near retirement
- **Participant specific factors ignored for asset allocation decisions**

ADVANTAGES

- **Simplistic**
- **Typically longer track records**
- **Typically diversification within each investment option**

PROFESSIONALLY MANAGED ACCOUNT - *Participants Defaulted by Multiple Factors into a Model Portfolio of Defined Contribution Menu Investments*

A managed account is a professionally managed investment portfolio using the investment options available to a participant in an employer-sponsored plan. A managed account uses traditional investment techniques with financial planning to arrive at a customized mix of investments for each participant. A sample model portfolio can be seen in Figure 2 on the next page.

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The account advisor recommends the mix based upon an understanding of each participant’s unique situation. Although data requirements are unique to each provider, common demographic variables used to determine the appropriate portfolio include age, salary, balance, employee deferrals, employer contributions, state of residence, gender, loans, years of plan tenure, pension benefits, company stock balance, and others.. Additional data often provided by the participant, such as risk tolerance, out-of-plan assets, spousal information, health factors, can also be incorporated. Such managed accounts also have tools and advice assistance on withdrawal strategies, deferrals types (Roth vs. Traditional), and other retirement income assistance. Fees are typically higher with a managed account as participants are charged for the account service on top of the underlying investment management fees.

Figure 2

| Sample 401(k) Investment Menu | Sample Managed Account Model Portfolio Recommended for a Participant (Objective: Growth and Capital Appreciation) |
|-------------------------------|---|
| U.S. Equity Manager | 55% U.S. Equity Manager |
| Non-U.S. Equity Manager | 15% Non-U.S. Equity Manager |
| Target Date Funds | |
| Core Fixed Income Manager | 25% Core Fixed Income Manager |
| Cash Equivalent Manager | 5% Cash Equivalent Manager |

MANAGED ACCOUNTS ADVANTAGES & DISADVANTAGES

DISADVANTAGES

- **Higher fees;** management fee in addition to investment option fees based on asset balance; younger participants may be disadvantaged with low account balances
- **Employers to provide sensitive participant data**
- **Difficulty in monitoring performance;** dependent on platform reporting capabilities

ADVANTAGES

- **Customized asset allocation;** Participant asset allocation determined by multiple factors may better position participants for retirement readiness
- **Potential holistic financial advice;** participants typically experience advice beyond investment allocation (e.g., savings rates) that may be desired by near-term retirees

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KEY DECISION FACTORS

Below and on the next page are initial questions a plan sponsor or fiduciary should consider when selecting a QDIA:

1. Do I understand the available QDIA options to the plan?
2. Have advantages/disadvantages of each QDIA been reviewed?
3. What are the demographics of the plan and which QDIA best serves this age cohort? Which QDIA best serves a younger/older work force?
4. Which QDIA best improves participant retirement readiness?
5. Do I have an investment consultant assisting with the selection and monitoring of the QDIA? If not, who is performing the due diligence?
6. Do I intend to follow the investment selection process outlined in the Investment Policy Statement for the QDIA selection?
7. Is the investment consultant assuming a fiduciary role?
8. Is the QDIA manager assuming a fiduciary role?
9. Is the investment consultant receiving a monetary benefit as a result of their recommendation on a QDIA product?
10. Is the recordkeeper or administrator receiving a monetary benefit as a result of the QDIA product?
11. What other service providers receive a fee from the QDIA selected?
12. Which QDIA is best suited to handle market volatility?
13. What are the range of fees participants pay for each option considered?
14. Which QDIA option provides a reasonable fee range? Has the "reasonable fee been benchmarked? Are both active and passive management styles considered in the fee reasonableness benchmarking?
15. How is the information on participant data communicated to the QDIA firm? Are appropriate cyber security measures in place?

Additional questions and due diligence should be considered once a QDIA product is selected, most notably with guidance from the 2013 DOL Tips Sheet on Target Date Fund selection.

Clearstead can assist plan sponsors with QDIA selection. We feel strongly that there is no "one-size-fits-all" approach and many considerations need to be reviewed, vetted, and discussed before a selection is made. An investment consultant, such as Clearstead, can assume a fiduciary role and recommend a QDIA and product for a plan sponsor that is most appropriate to the plan's participants.

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