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Not so simple:

*Why target-date funds are widely
misused by retirement investors*



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EXECUTIVE SUMMARY

The use of target-date funds (TDFs) in defined contribution retirement plans has increased rapidly since they were approved as a Qualified Default Investment Alternative (QDIA) under the Pension Protection Act (PPA) of 2006. This growth has been driven by plan sponsors who often default new hires into TDFs. TDFs have been used in some form by approximately 41 percent of retirement plan participants.¹ On its face, this would appear to demonstrate success. Yet, 10 years after the passage of the PPA, how much do we know about the ways TDFs are being used by retirement plan investors?

TDFs are designed to hold **all** of an investor's plan assets in a single, diversified fund aligned with the investor's expected retirement date. It has been widely assumed that inertia would cause participant assets defaulted into TDFs to stay invested for the long-term. However, prior research by Financial Engines and Aon Hewitt revealed that the majority (62 percent) of TDF users invest **only part** of their plan assets into their TDF.² The same research study found that only 57 percent of people who started out with almost all of their assets invested in TDFs were still fully invested in TDFs five years later.³ Moreover, the study found that this partial-TDF approach resulted in 2.11 percent lower median annual returns, net of fees, than investors who held almost all of their retirement assets in TDFs.⁴ The high incidence of partial-TDF usage, and the evidence that such partial-TDF users significantly underperform more appropriately diversified investors, calls into question the efficacy of relying solely on TDFs to achieve retirement security for plan participants.

This study seeks to better understand *why* many retirement investors hold only part of their retirement plan assets in TDFs and why they decrease their allocation to TDFs over time. This study also shares implications of these findings for retirement plan designs.

To answer these questions, Financial Engines surveyed a representative sample of over 1,000 full-time employees who have a TDF available to them through their workplace retirement plan. The following sub-groups were analyzed:

- **full-TDF users who currently invest 90 percent** or more of their plan assets in TDFs;
- **partial-TDF users who currently invest less than 90 percent** of their assets in TDFs;
- **non-users who do not currently have any assets** invested in TDFs, and;
- **“Decreasers”** who were more invested in TDFs in the past but **who have moved part or all of their assets away from TDFs.**

Key findings include:

- A. Only a fraction—one in four—of total TDF users are full-TDF users who utilize their TDF as intended by holding virtually all (90 percent or more) of their investments in TDFs. **Full-TDF users differ markedly from the average plan participant—they are much younger and earn lower income, have lower plan assets and save a smaller portion of their income.** They are also **less confident** than the average investor that their assets are appropriately invested. The vast majority (75 percent) of full-TDF users were defaulted into TDFs. TDFs work well for this group of retirement investors seeking an easy way to manage their retirement investments that requires little engagement or effort on their part. However, the beneficial impact of full-TDF use on plan assets is limited due to the small proportion using this product as intended. In fact, full-TDF users held only 24 percent of the total assets of participants holding any position in TDF funds, and represent only 10 percent of all retirement plan assets.⁵ In other words, 90 percent of defined contribution plan assets are not being beneficially impacted by the appropriate use of TDFs, despite widespread default usage as a QDIA.
- B. The majority (two out of three) of TDF users hold only part of their investments in TDFs, potentially harming their returns.ⁱ **Partial-TDF users more closely resemble the average participant in terms of age, personal income, and plan assets—they tend to be mid-career employees with average-size asset balances. Compared to full-TDF users, they were older, with higher balances.** They mirrored the average investor on other variables studied such as risk tolerance, confidence that assets are appropriately invested and reported level of understanding of TDFs. Those who decreased their TDF investments tend to be particularly **overconfident**: 62 percent believe that they can achieve better returns through their own investing than can be achieved by relying on TDFs, despite evidence to the contrary. Partial-TDF users held 76 percent of all TDF assets.

ⁱ 10 percent of participants in the study reported being unsure of whether they were partial- or full-TDF users.

C. **Partial-TDF users cited the following key reasons for not investing all of their money in TDFs:**

- **They were seeking to diversify their investments and avoid “putting all their eggs in one basket” cited by 62 percent of partial-TDF users.** Despite accurately understanding that TDFs are diversified (81 percent reported that they know this), they were still seeking greater portfolio diversification. They appear to be seeking diversification beyond investment diversification, for instance, diversification across investment funds or asset managers. This suggests that TDFs may have a behavioral flaw that may limit their long-term ability to address the needs of mid-career participants with average-sized asset balances. This potential flaw may not be addressable through more education about how TDFs work.
- **They were seeking greater personalization than TDFs offer,** especially with respect to their risk tolerance, cited by half of partial-TDF users.

Decreasers, who have moved part or all of their assets away from TDFs, cited the same top reasons for moving their money away from TDFs. Moreover, Decreasers said they **were seeking more personal management or advice on their retirement investments** from an advisor, cited by 58 percent of Decreasers. This suggest investors seeking advice could be a catalyst for TDF abandonment.

D. Conclusion and implications: TDFs appear to be most effective for younger investors with low asset balances and others with less complex financial needs. Advisory services, including **managed accounts, can better address the needs of investors who have greater financial complexity outside their retirement accounts** by providing portfolios that are diversified across multiple funds, offer greater personalization including a range of risk levels, and the ability to speak with financial advisors about various retirement needs. Importantly, users of managed accounts more closely match the average plan participant in terms of demographics—mid-career employees with average-size asset balances—than do the users of full-TDFs, suggesting that managed accounts are a potentially good solution for the typical plan participant. Thus, **managed accounts can play a crucial complementary role to TDFs** in a well-designed workplace retirement plan.

New best practices are emerging to ensure that retirement plan participants get to the right solution for their needs. For the past ten years, many plan sponsors have automatically enrolled new hires into TDFs, a practice that has indeed helped millions of new investors save for retirement. A huge part of this success is due to using TDFs as the default investment option, with younger employees benefitting the most from this practice.

A similar behavioral nudge is needed to help older mid-career workers. Leading plan sponsors are now refining their automatic enrollment practices by also beginning to default older existing employees into managed accounts and other advisory services, which better meet their more complex needs not addressed by TDFs.

Plan sponsors wishing to better serve their existing employees, who are now self-directing their balances and often misusing TDFs, could refine their default practices by:

1. **adding personalized advisory services, such as managed accounts**, as a complement to TDFs in their plans,
2. continuing to **default young new hires into TDFs**,
3. **defaulting older new hires into managed accounts**, and
4. defaulting **(re-enrolling) existing participants who are over a certain age and/or partial-TDF users into managed accounts**.

This approach aligns with a separate study by Financial Engines showing that two-thirds of retirement plan consultants interviewed consider **TDFs and managed accounts as complementary parts in a well-designed retirement plan**.⁶

This research study builds upon previous research documenting the common misuse of TDFs by adding new insights about **why** people are misusing these products. The results of the survey suggest that TDFs, while beneficial for new employees with smaller balances, suffer from critical limitations that lessen their effectiveness with employees as they age and accumulate larger balances.

While the trend of using TDFs as a QDIA has been of value to many participants, it remains critical for plan sponsors to continue evolving plan designs based on evidence of what is or is not working well for the different segments of their employees. More American workers could achieve retirement success if more plan sponsors adopted the best practice of adding advisory services, such as managed accounts, as a complement to TDFs in their retirement plans and automatically re-enrolling older workers into managed accounts.

INTRODUCTION

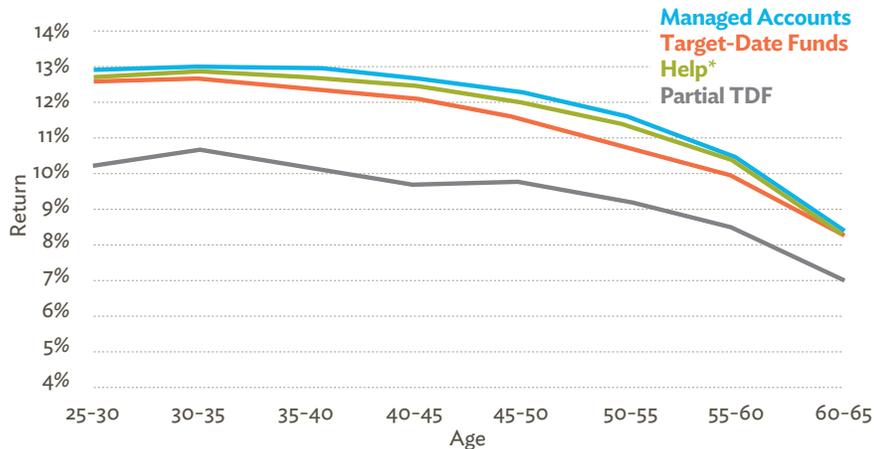
Target-date funds are growing in popularity, but common usage patterns reveal concerns

According to research by the Investment Company Institute and the Employee Benefit Research Institute, target-date funds (TDFs) usage has doubled in less than ten years, growing from 19 percent of retirement investors in 2006 to 41 percent in 2012.⁷ The vast majority (72 percent) of employer plan sponsors have opted to designate TDFs as their plans' Qualified Default Investment Alternative (QDIA), enabling them to default employees into this investment option.⁸

Plan sponsors have laudable goals of helping employees achieve a secure retirement by providing an option for investment diversification of retirement assets within a defined contribution plan. TDFs are designed to hold **all** of a participant's retirement assets and to automatically adjust their asset allocation toward more conservative investments as they reach their target retirement date and often through retirement. TDFs intend to provide investment diversification through a product without the need for financial advisors. The reality, however, is that TDFs tend not to be used as the "one-stop" solution they were designed to be.

Our survey of retirement investors found that almost two-thirds of TDF users misused their TDFs by holding **only part** of their investments in a TDF. On an asset basis, the partial usage of TDFs is even more stark—76 percent of TDF assets are held by partial users. Moreover, independent analysis by Financial Engines found that partial-TDF users had 2.11 percent lower annual returns, net of fees, than investors who held almost all of their retirement assets in TDFs.⁹ If these lower annual returns persisted, this could have a detrimental impact on asset accumulation over a lifetime. Thus, understanding what is motivating retirement investors to be partial-TDF users is critical since partial-TDF usage is harming their investment returns and making it harder for investors to achieve their retirement goals.

Figure 1. Comparative Median Returns, 2010-2012



*Help: includes returns from TDFs, managed accounts and online advice.

Source: Help in Defined Contribution Plans: 2006-2012 (Sunnyvale: Financial Engines and Aon Hewitt, 2013).
<https://corp.financialengines.com/employers/FinancialEngines-2014-Help-Report.pdf>

With this study, Financial Engines sought to better understand the psychology of TDF users by:

1. learning more about **why** many retirement investors choose to hold **only part** of their workplace retirement investments in TDFs and why many TDF investors choose to **move money out** of their TDFs; and,
2. understanding how full-TDF users differ in their knowledge, characteristics and attitudes toward TDFs from the typical retirement investor, from partial users and from retirement investors who have chosen not to invest in TDFs.

To accomplish this, Financial Engines queried and compared responses from full- and partial-TDF users and those who are not invested in TDFs. Financial Engines also examined those who have decreased their investments in TDFs.

A final purpose of this study was to provide information to help retirement plan sponsors better understand how employees view TDFs and the possible drawbacks of relying on TDFs as the sole solution for providing professionally managed allocations to their employees. This information can be used by plan sponsors and consultants to determine new approaches to retirement plan designs that can address the major concerns with TDF usage by plan participants.

RESEARCH METHODOLOGY

Financial Engines commissioned an online survey of full-time employees between the ages of 18 and 70 who participate in their employer's defined contribution plan, such as a 401(k), 403(b) or 457 plan, and who report that their employer plan had TDF options available to retirement investors. This online survey was fielded between September 16 and September 24, 2015, and gathered information from 1,013 retirement investors.

A two-stage procedure was used to weight the survey data. First, all screened respondents were weighted by age, gender and income to reflect the national population of retirement plan participants between ages 18 and 70, according to the Current Population Survey, a product of the United States Census Bureau. Next, the final sample of qualified respondents was weighted to correct for oversampling of certain quota groups. Relevant subgroup findings are presented where there are significant differences within the subgroup (at the 95 percent confidence interval). Percentages in the tables and charts may not total to 100 due to rounding and/or omitted categories.

(To see a detailed profile of the survey respondents, please refer to Appendix 1.)

KEY FINDINGS

Trends in TDF usage

How TDFs are used now

The majority (58 percent) of retirement investors are not invested in TDFs. Of those who use TDFs, only one in four are full-TDF users.

Among all retirement investors, 58 percent reported not investing any retirement assets in TDFs, while 38 percent reported having at least part of their assets invested in a TDF. The data reported by survey respondents align with other studies, such as the Investment Company Institute research study entitled *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012*, which showed that 41 percent of retirement investors used TDFs in some form.

Among all retirement investors, 27 percent are partial-TDF users and another 11 percent are full-TDF users. This self-reported data about TDF usage aligns with previous studies documenting actual use of TDFs such as *Help in Defined Contribution Plans* by Financial Engines and Aon Hewitt, which found that 28 percent of all retirement investors are partial-TDF users, and 17 percent are full-TDF users.

Focusing on TDF users, only one in four (26 percent) report using their TDFs as designed by investing at least 90 percent of their retirement assets in their TDF. Thus, only a minority of all TDF users are full-TDF users actually reaping all the benefits of age-appropriate investment diversification promised by TDFs.

The vast majority of TDF users report using their TDFs in a way that was **not** intended by TDF designers. Sixty-four percent of TDF users reported being partial users who allocate less than 90 percent of their assets to TDFs. (Another 10% were not sure of their TDF allocation.) Fully one-third of TDF users report allocating less than 25 percent of their assets to TDFs—far from the “one-stop shop” solution that was anticipated by the original TDF designers.

In addition, nearly one in six (15 percent) of retirement investors stated that they are “Decreasers.”ⁱⁱ This means they have moved either all or some of their retirement investments away from their plan’s TDF by decreasing their contributions to TDFs or shifting their assets into other investments in their retirement plan. Decreasers resemble

ⁱⁱ The study *Help in Defined Contribution Plans* showed that only 57 percent of people who started out with almost all of their assets invested in TDFs were still fully invested in TDFs five years later.

partial-TDF users, since 66 percent of Decreasers are partial-TDF users, while 33 percent are no longer invested in TDFs.

Figure 2. TDF use among all retirement investors

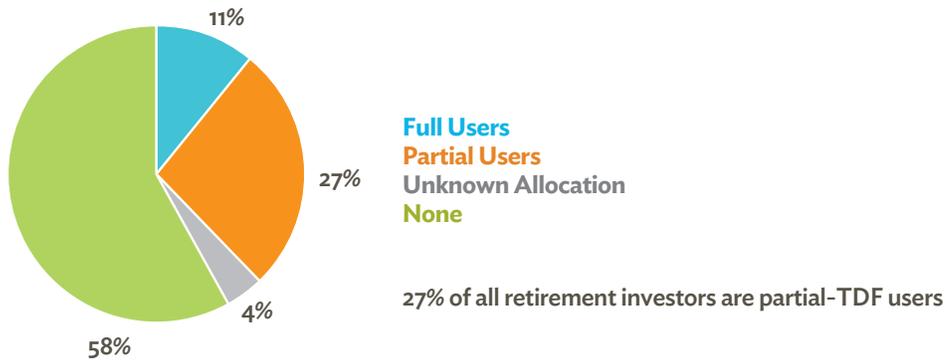
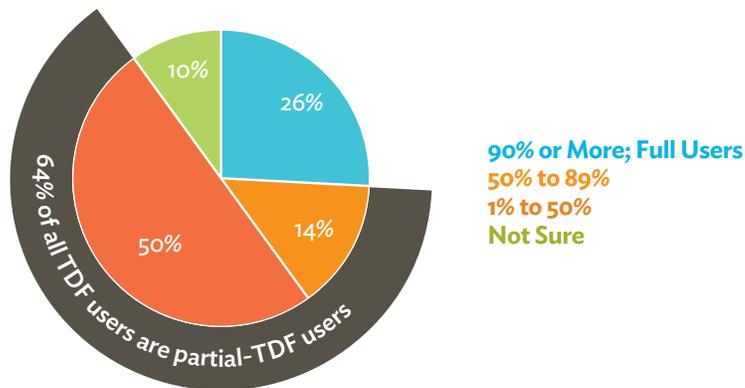


Figure 3. Proportion of portfolio allocated to TDFs



Profile of who uses TDFs

We profiled the differences in characteristics among the following sub-groups:

- full-TDF users who currently invest 90 percent or more of their plan assets in TDFs,
- partial-TDF users who currently invest less than 90% of their assets in TDFs,
- non-users who do not currently have assets invested in TDFs and
- Decreasers who have moved either all or some of their retirement investments away from their plan's TDF.

Full-TDF users differ markedly from the average plan participant—they are much younger, earn lower incomes, have lower plan assets and save a smaller portion of their income. In addition, compared to the average participant, full-TDF users give much less thought to their retirement plan investments, and are much more likely to have been **automatically enrolled** in a TDF. Finally, compared to the typical plan participant, full-TDF users tend to say they:

- **tolerate lower risk,**
- **have less confidence** that their retirement assets are appropriately invested and
- claim a **lower understanding of TDFs.**

Partial-TDF users more closely resembled the average participant in terms of age, personal income and plan assets as well as on other variables studied, such as risk tolerance, confidence that assets are appropriately invested and reported understanding of TDFs.

Figure 4. Percent of retirement investors who are full- or partial-TDF users or non-users*

	All Retirement Investors Surveyed	Full Users	Partial Users	Non Users
Percent male	67%	59%	65%	71%
Age 45-70	52%	42%	52%	55%
Personal income	37% >\$75,000 8% \$150,000+	35% >\$75,000 4% \$150,000+	41% >\$75,000 9% \$150,000+	36% >\$75,000 9% \$150,000+
Plan assets	50% >75,000 20% \$250,000+	42% >75,000 13% \$250,000+	52% >75,000 22% \$250,000+	52% >75,000 21% \$250,000+
Saved 10% or more income in retirement plan	43%	33%	48%	44%
Thought a great deal about plan investments	36%	15%	40%	39%
Agree with “set it and forget it” approach to retirement plan	39%	60%	44%	32%
Use an advisor	35%	31%	43%	32%
Automatically enrolled into TDFs	27%	75%	40%	5%
Considerable risk tolerance	18%	9%	19%	20%
Very confident that assets are appropriately invested	30%	23%	29%	34%
Claim to understand TDFs very well	27%	15%	30%	29%

*How to read this table: Of all full-TDF users surveyed, 59 percent are male. Of all full-TDF users, 42 percent are between the ages of 45 and 70. Of all full-TDF users, 35 percent have personal income above \$75,000.

Decreasers share many characteristics with partial-TDF users as most (66 percent) of them are partial-TDF users. However, Decreasers are **younger** than partial users: 60 percent of Decreasers and 48 percent of partial-TDF users are age 18 to 44. Also, Decreasers tend to be **more confident** in their investments—38 percent of Decreasers and 29 percent of partial users said they were “very confident” that their retirement savings were invested appropriately. Decreasers were also more likely than partial users to **claim a “very high” understanding of TDFs**—40 percent versus 30 percent. (See Appendix 2 for more detailed information about characteristics of Decreasers.)

Comprehension of TDFs

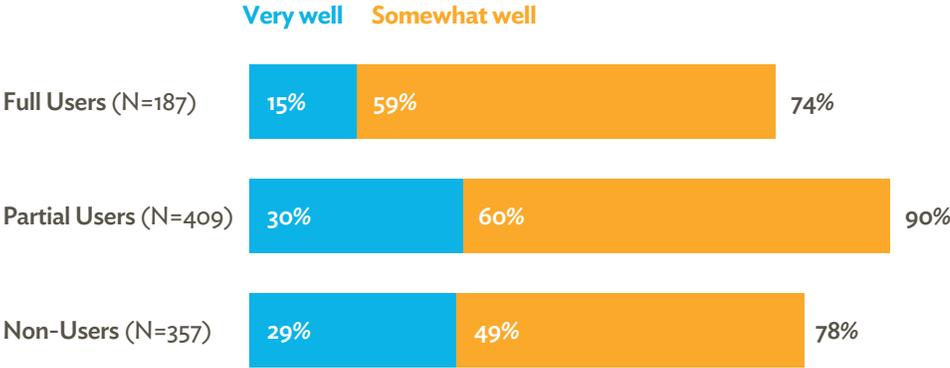
How well do retirement investors understand TDFs?

Partial-TDF users were more likely to claim a high level of understanding of TDFs, even though they are not using their TDFs as intended. Alternately, full-TDF users are using their TDFs as intended even though only a small proportion of them claim to have a high level of knowledge about their TDFs.

Partial users claim the highest level of understanding with 90 percent reporting they understand their TDF very or somewhat well.

Partial-TDF users were twice as likely as full-TDF users—30 percent compared to 15 percent—to report that they understand TDFs “very well.” Full-TDF users state that they do not understand TDFs very well, yet they are the ones who are actually using their TDF appropriately. In contrast, partial-TDF users are using their TDFs in a way that was not intended and is associated with lower returns, according to previous research by Financial Engines and Aon Hewitt.¹⁰

Figure 5. Percent of full-, partial- and non-TDF users who report they understand TDFs very or somewhat well

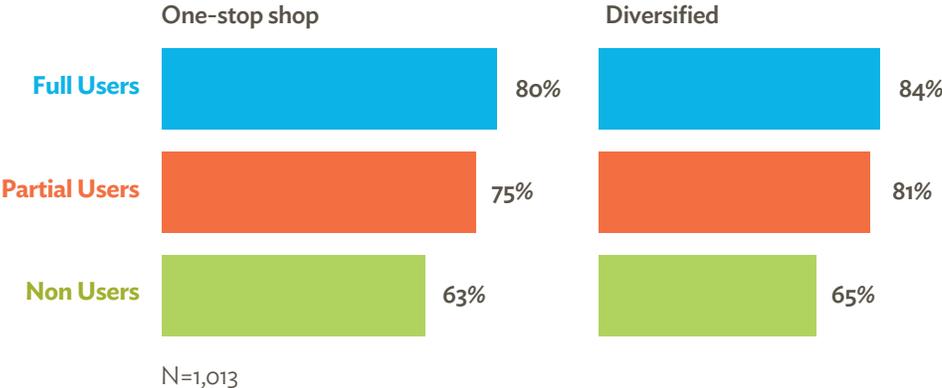


How well do retirement investors actually understand key features of TDFs?

Key features of TDFs are well understood by the majority of retirement investors. In particular, partial-TDF users are well aware that TDFs are diversified.

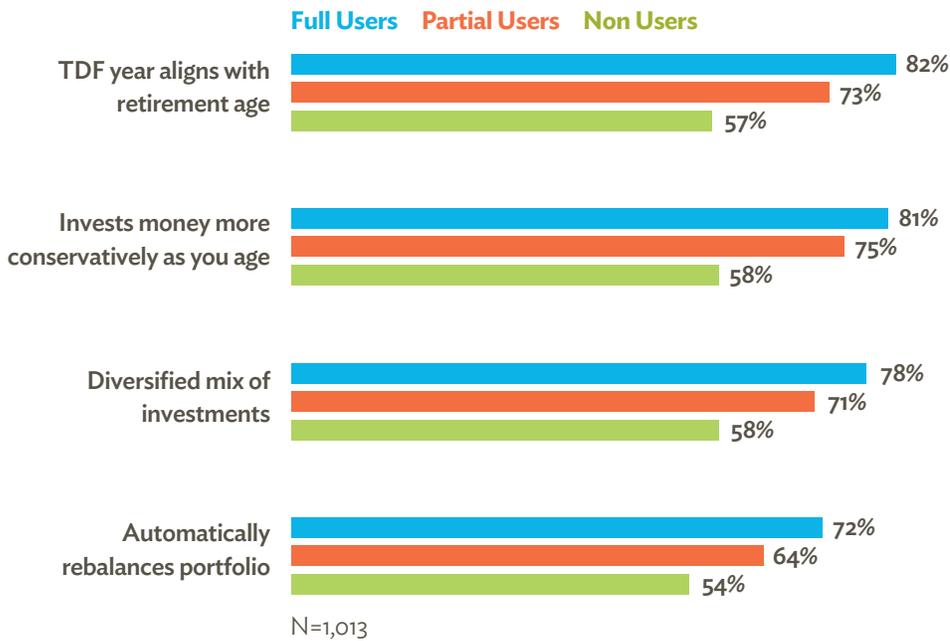
The vast majority—81 percent—of partial-TDF users stated that “diversified” describes TDFs very or somewhat well. Thus their partial use of TDFs does not seem to be explained by a lack of understanding about how TDFs work.

Figure 6. Percent of retirement investors who agreed that the terms describe TDFs very or somewhat well



When queried about the possible advantages of TDFs, large portions of full- and partial-TDF users answered in a way that shows they understood many key features of TDFs, including: aligns with retirement age, invests more conservatively as you age, and includes a diversified mix of investments.

Figure 7. Percent of retirement investors who agreed that the statements are a possible important advantage of a TDF



However, while partial-TDF users claimed more frequently to understand TDFs very well in general, they were more likely to misunderstand some key points. One-quarter of partial users falsely believe that TDFs guarantee that they won't lose money, versus only 8 percent of full-TDF users and 11 percent of non-users.

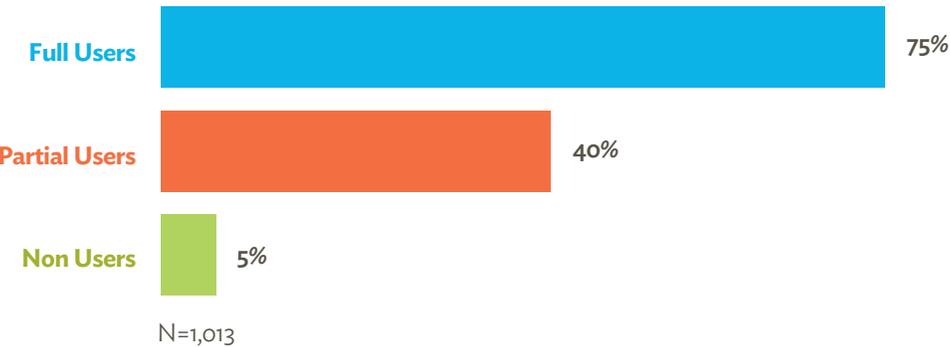
Reasons retirement investors are full-, partial-, non-TDF users or Decreasers

Full-TDF users

Most full-TDF users (75 percent) use TDFs because they were automatically enrolled into their TDF by their employer. In addition, full-TDF users like TDFs because they are easy to use and require little action on their part.

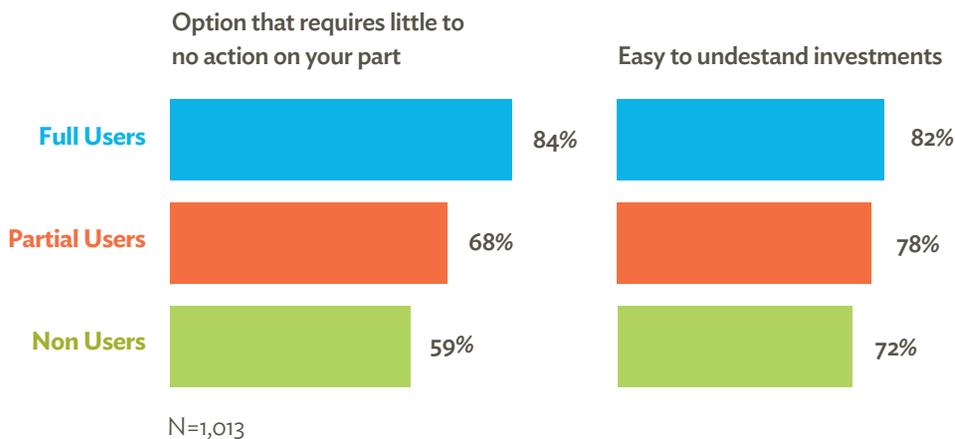
Among full-TDF users, 75 percent said they were automatically enrolled into their TDF versus 40 percent of partial users and 5 percent of non-TDF users. Only 25 percent of plan participants who are full-TDF users actively selected the investment themselves. If employees are not defaulted into TDFs, they are very unlikely to end up fully invested in TDFs on their own. This is consistent with the findings of other industry studies such as *Help in Defined Contribution Plans*, which found that 89 percent of full-TDF users were defaulted into the fund, and The Vanguard Group’s study, entitled *Target-date fund adoption in 2013*, which found that 60 percent of “pure” TDF holders were automatically enrolled.¹¹

Figure 8. Percent of retirement investors who were automatically enrolled in TDFs



In addition, full-TDF users were more likely than partial- and non-TDF users to agree that it is important to select an investment option that “requires little or no action on your part” and that is “easy to understand.” Women were also more likely than men to say that it was important to select an investment option that was “easy to understand”—81 percent of women said it was important versus 71 percent of men.

Figure 9. Percent of retirement investors who agree that it is very or somewhat important to select an investment option with these qualities



Partial-TDF users

The top reasons that partial-TDF users chose to add other investments to their TDF are:

- to diversify their investments, and
- to personalize the risk level of their investment mix.

In addition to these same top reasons, Decreasers moved money away from TDFs because they wanted more personal management or advice on their investments.

As shown in figure 10, the top reason that partial-TDF users cite for adding other investments to their portfolio is to “diversify their investments.” **This is surprising because 81 percent of partial-TDF users said “diversified” is a term that describes TDFs.** The vast majority of partial-TDF users appear to accurately understand that TDFs are already diversified, yet they are adding other investments to their TDF to further diversify their investments. The TDFs’ diversified underlying investments do not seem to satisfy their desire for diversification.

The confusion may be due to a belief that appropriate portfolio diversification requires spreading assets across different funds. Or it may reflect concerns with being overly exposed to a single investment fund or fund manager. In either case, the fact that partial-TDF users already know that TDFs are diversified means that additional investor education about how TDFs work will not likely result in more appropriate use of TDFs.

In addition, the majority of partial-TDF users (53 percent) do not see the feature “designed for you to put all of your retirement plan money into it” as an advantage of TDFs. In open-ended responses many survey respondents stated that they essentially did not want to put all their retirement assets into one investment option. Some responses in their own words were as follows:

“Because you never know what could happen and I don’t want all my money in there.”

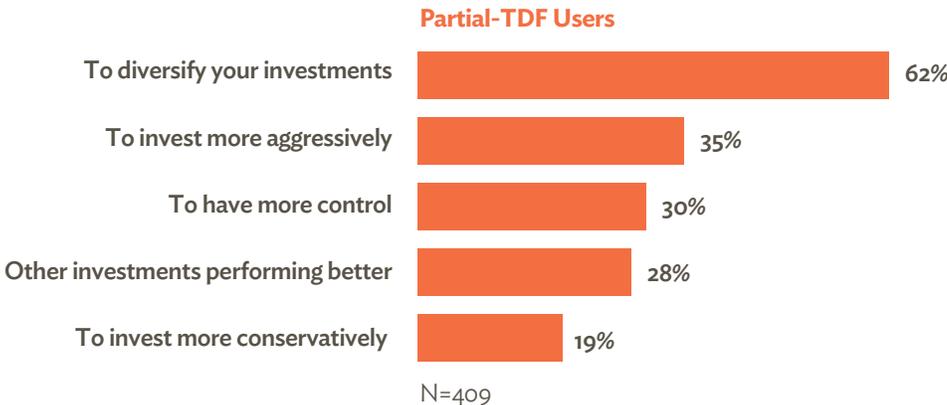
– Female, age 29

“I do not like having all of my eggs in one basket.” – Female, age 24

“I did not want to put everything in the same tool. I wanted to try some higher risk investments.” – Male, age 64

“I like the strategy of the Target Date, but also want to invest in specific stocks and bonds.” – Female, age 51

Figure 10. Reasons partial-TDF users chose to invest in other funds in addition to TDFs



The second most common reason for partial-TDF use involved personalizing the risk level of their investments. Half of partial-TDF users find the TDF’s generic risk level to be unsuitable for them.

One reason for choosing a partial-TDF approach was “to invest more aggressively,” as chosen by 35 percent of partial-TDF users on a multiple choice question. Nineteen percent said they wanted to “invest more conservatively.” The survey also included open-ended questions about why partial-TDF users and Decreasers moved away from TDFs. Below are responses from survey participants that illustrate their desire for a better match to their personal risk level.

“I like to be more aggressive and target funds are quite conservative.” – Male, age 35

“I wanted to be a little more risky with my funds and I felt the target-date funds were too risk averse. I’m still young so I want to grow my money a little faster and also think more about where I put my money instead of just putting it on autopilot.” – Male, age 37

*“I’m getting closer to retirement and want to be more conservative with the funds.”
– Female, age 50*

“I feel the target funds are too aggressive with stocks.” – Male, age 47

The third most common reason for adding other investments to their TDFs was to have “more control over their investments” with 30 percent of all partial-TDF users citing this as a reason.

Mirroring partial-TDF users, Decreasers—participants who have moved part or all of their investments away from TDFs—named the same top three reasons for moving their money away from TDFs. **In addition, a top reason Decreasers moved money away from TDFs was a desire for more personal management or advice on their investments with 58 percent of Decreasers naming this reason.**

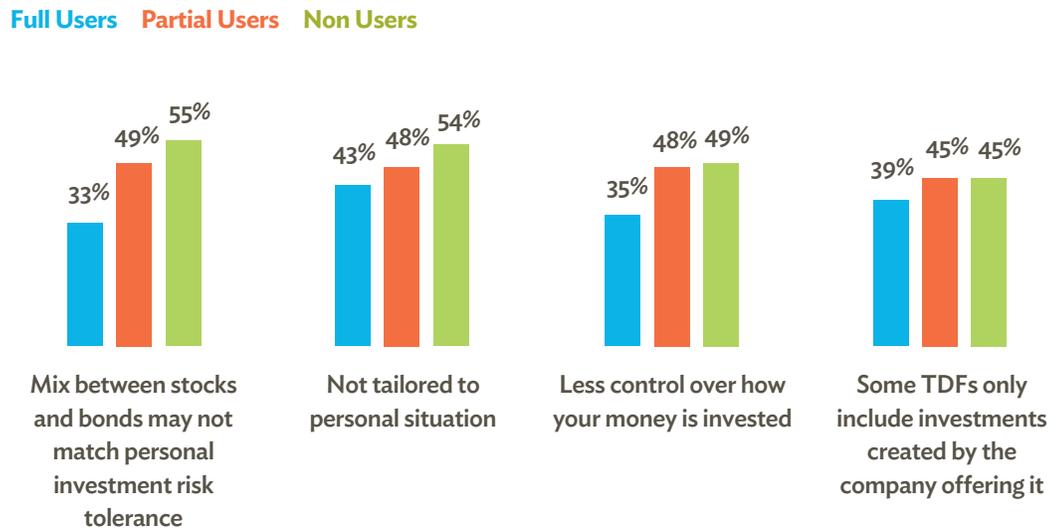
The reasons partial-TDF users and Decreasers moved away from TDFs align closely with the disadvantages they perceive about TDFs.

Partial-TDF users are consistently more likely than full-TDF users to name these as TDF disadvantages:

- lack of personalization,
- lack of personalized risk level and
- less control over investments.

Also, almost half (45 percent) of partial- and non-TDF users agree that a disadvantage of TDFs is that “TDFs only include investments created by the company offering it.” This is another indicator pointing to why partial- and non-TDF users avoid putting all of their money into a TDF.

Figure 11. Percent who agree that the statement is a somewhat or very important disadvantage of TDFs

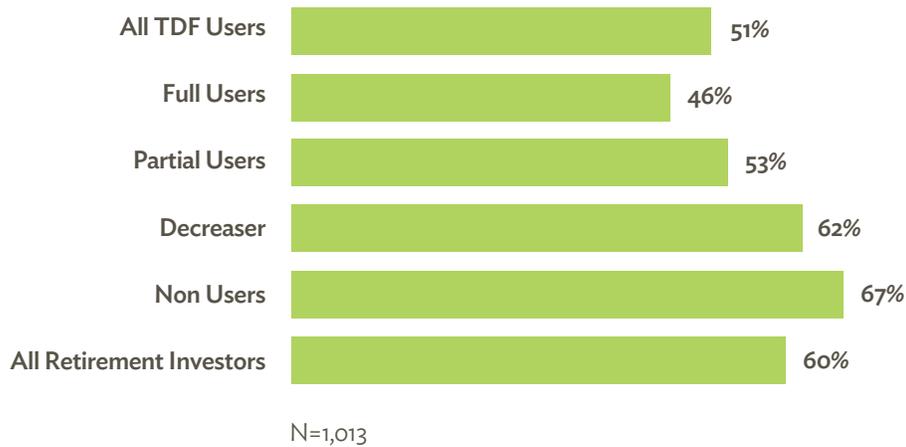


N=1,013

About half (51 percent) of all TDF users **do not** agree that TDFs can get better investment returns than they can get on their own. Fifty-three percent of partial-TDF users, 46 percent of full-TDF users and 62 percent of Decreasers **do not** agree that TDFs can get better returns than they can get on their own. In addition, 67 percent of non-TDF users do not agree that TDFs can achieve better returns. Overall, six out of ten (60 percent) retirement investors do not believe that TDFs can get better returns than they can get on their own.

Compared to other TDF users, Decreasers appear to be particularly overconfident in their own investing skills because they are more likely to believe that they can get better returns on their own than their TDF can deliver, despite evidence to the contrary. This points to the possibility that overconfidence in personal investing skills may be another key factor leading to the movement of assets away from TDFs.

Figure 12. Percent of retirement investors who do not agree (bottom 3 on Scale of 1 to 5) that TDFs “can get better returns than you can get on your own”

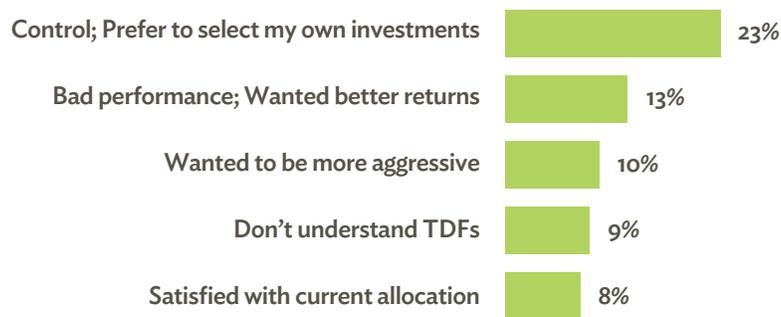


Non-TDF users

Control and performance are the top reasons that over half of retirement investors say they have chosen not to invest in TDFs.

The majority (55 percent) of retirement investors are not currently invested in TDFs though they report that TDFs are available to them in their employer plan. Their top reasons for not investing in TDFs are a desire for more control of their investments (23 percent) and for better performing investments (13 percent). Unlike partial-TDF users, whose top reason was a desire for greater diversification, those who are not invested in TDFs are more focused on control and performance.

Figure 13. Reasons non-TDF users have chosen to not invest in TDFs (frequency of responses to open-ended question)



Participants who never invested in TDFs
N=552

Some responses to why some investors have chosen to not invest in TDFs in their own words include:

“I can get better returns from other options in my plan. TDFs tend to be a little more conservative in their approach than I want to be at this point in my life.”

– Male, age 52

“I wanted to have more control over my investment and allocate my funds appropriately as I want to.” – Male, age 24

“Don’t want to automate savings, like to choose my own funds.” – Female, age 33

Managed accounts address many of the concerns that partial-TDF users have about TDFs

How managed accounts work

Managed accounts provide professional management of 401(k) assets. The professional manager makes on-going investment decisions on behalf of clients, such as making asset allocations, selecting investments from within the employer retirement plan and monitoring and rebalancing of portfolios. Clients receive a portfolio that is clearly diversified across multiple investment funds available through their employer plan. Managed accounts can be personalized with information specific to the client, such as investment objective (for example, growth or income), planned retirement age, risk tolerance and other assets outside the 401(k) plan. Managed accounts can also provide access to financial advisors. Managed accounts typically do not allow for partial usage; the member's entire 401(k) account must be enrolled in the program. Managed accounts were approved as a QDIA in the Pension Protection Act of 2006, but are not frequently used as the default investment option in retirement plans. Almost all managed account users actively enroll in managed accounts. According to Aon Hewitt, 55 percent of retirement plans surveyed offered managed accounts in 2015.¹²

How managed accounts address concerns with TDFs

Diversification: Clients receive a portfolio that is visibly diversified across multiple investment funds available through their employer plan.

Personalization: Managed accounts can be personalized with information specific to the client, such as investment objective, planned retirement age, risk tolerance and other assets outside the 401(k) plan.

Advisor access: Managed accounts can provide access to financial advisors.

Fidelity Investments surveyed plan sponsors and participants in its managed account program to learn why they are increasingly using managed accounts. Users cited the following as the major reasons to enroll in managed accounts:

- to maximize account growth (59 percent),
- to ensure proper diversification based on unique goals (49 percent), and
- to work with a professional (45 percent).¹³

Various studies have documented the value of managed accounts to retirement investors, including *Help in Defined Contribution Plans 2006-2012* by Financial Engines, and a recent report by The Vanguard Group entitled *The Value of Managed Account Advice* published in 2015.¹⁴ These studies show that “Help” users (defined as primary TDF holders, managed accounts and online advice) receive over three percent higher median annual returns, net of fees than “Non-Help” users; and managed account users have more appropriate portfolio risk levels and higher savings rates compared to investors who do not utilize managed accounts.

CONCLUSION AND IMPLICATIONS

Key limitations of TDFs:

This study revealed many of the key limitations of TDFs in the minds of TDF users. This study found that partial-TDF users and those who have decreased their TDF investments moved away from TDFs because they were seeking to:

- **diversify their investments** and avoid “putting all their eggs in one basket;”
- **personalize their portfolios**, especially with respect to their risk tolerance; and
- **receive investment help from an advisor.**

What’s working:

This study also confirmed that TDFs represent a strong solution for one-quarter of retirement investors who, compared to the typical retirement investor, are much younger, have fewer assets and use TDFs as they were intended by investing all of their retirement assets into their TDF. Thus, it is important to continue to offer TDFs as part of workplace retirement plans. Appropriate use by younger participants also illustrates that the use of TDFs as the default for younger new hires is appropriate in many cases.

What’s not working:

Yet, TDFs are not working well for the majority of TDF users who are partial-TDF users and who more closely resemble the average retirement investor in age (mid-career), assets and knowledge about investments. They are averse to putting all of their retirement savings into one investment option. As a result, they misuse their TDF by adding other investments in an effort to better satisfy their needs for diversification and personalization, but at a possible cost of two percent lower annual returns, net of fees, and long-term harm to their retirement nest eggs. They also want more professional management and advice on their retirement investments.

Role of advisory services, including managed accounts:

Advisory services, such as managed accounts, with personalization, access to advisors and professionally managed portfolios that are clearly diversified across multiple investment funds, can address the top concerns about TDFs identified by partial-TDF users, who closely resemble the typical plan participant.

Implications for plan designs:

The implications for employers designing retirement plans for their workers are clear—adding advisory services, such as managed accounts, to a retirement plan can ensure that the more complex needs of mid-career employees with average-sized nest eggs can be met. Moreover, it is important to view managed accounts as a crucial complement to TDFs in retirement plans that are made available to employees in addition to—not instead of—TDFs. Managed accounts should be made available for mid-career participants with average asset balances and outside investments, while TDFs remain a strong solution for employees who are younger and those with less complicated finances.

An optimal way of doing so would be to re-enroll into managed accounts new or existing plan participants who are over a certain age and who are partial-TDF users. Such a plan should still default new younger hires into TDFs, as they represent a good solution for this group. This approach aligns with a separate study by Financial Engines showing that two-thirds of retirement plan consultants interviewed consider **TDFs and managed accounts as complementary parts in a well-designed retirement plan.**¹⁵

TDFs have played an important role in improving retirement outcomes for many American workers in the 10 years since the passage of the Pension Protection Act. It remains critical for retirement plan sponsors to continue evolving plan designs based on evidence of what is or is not working well. Adding managed accounts as a complement to TDFs in workplace retirement plans is a key best practice to ensure more American workers achieve retirement success.

DEFINITIONS

Retirement investors/plan participants: Plan participants are employees who are actively saving in their employer-sponsored retirement plan. This study uses the terms “plan participants” and “retirement investors” interchangeably.

Target-date funds (TDFs): These funds include a diversified mix of investments that adjust automatically based on your age and the target retirement date or year.

Full-TDF users: currently invest 90 percent or more of their plan assets in TDFs.

Partial-TDF users: currently invest more than 1 percent and less than 90 percent of their assets in TDFs.

Non users: do not currently have assets invested in TDFs.

Decreasers: were more invested in TDFs in the past, but have moved part or all of their retirement plan assets away from TDFs.

Managed accounts: Provides professional management of 401(k) assets. The professional manager makes on-going investment decisions on behalf of the clients such as making asset allocations, selecting investments from within the employer retirement plan and monitoring and rebalancing of portfolios. Managed accounts can be personalized with information specific to the client such as planned retirement age, risk tolerance and other assets outside the 401(k) plan. Managed accounts provide access to financial advisors. Managed accounts do not allow for partial usage; the member’s entire 401(k) account must be enrolled in the program.

Managed account users: Plan participants who enroll in managed accounts.

Online advice: Provides participants with specific savings and investment recommendations for their 401(k) accounts. It is up to the participant to implement the online advice at a time of their choosing.

Online advice users: Plan participants who receive online investment advice at least once within the last 12 months.

APPENDIX

1. Profile of all survey respondents

N=1,013

Gender	
Male	67%
Female	33%
Age	
18 to 24	4%
25 to 34	19%
35 to 44	25%
45 to 54	29%
55 to 64	21%
65 to 70	3%
Employment status	
Working full-time	100%
Participation in retirement plan	
Actively chose to participate	85%
Automatically enrolled	15%
Not sure	*
Percentage of income contributed to retirement plan	
Less than 5%	17%
5 to 9%	36%
10 to 14%	21%
15% to 19%	9%
20% or more	12%
Not sure	4%

Personal income

Under \$25,000	7%
\$25,000 to \$49,999	29%
\$50,000 to \$74,999	28%
\$75,000 to \$99,999	16%
\$100,000 to \$149,999	12%
\$150,000 or more	8%

Total value of investments

Less than \$10,000	9%
\$10,000 to \$24,999	8%
\$25,000 to \$49,999	7%
\$50,000 to \$74,999	6%
\$75,000 to \$99,999	6%
\$100,000 to \$199,999	16%
\$200,000 to \$299,999	14%
\$300,000 to \$399,999	7%
\$400,000 to \$499,999	6%
\$500,000 to \$999,999	14%
\$1,000,000 to \$1,499,999	4%
\$1,500,000 to \$1,999,999	1%
\$2,000,000 or more	3%

2. Characteristics of decreaseers

Percent male	67%
Age 18-44	60%
Personal income	43% >\$75,000 12% \$150,000+
Plan assets	48% >\$75,000
Save more than 10 percent of salary	49%
TDF usage	66% Partial 25% None
Thought a great deal about plan investments	44%
Very confident that plan assets are invested appropriately	38%
Claim to understand TDFs very well	40%
Currently use a financial advisor	48%

Endnotes

¹ Holden, Sarah, Jack VanDerhei, Luis Alonso, and Steven Bass. 2013. “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012.” ICI Research Perspective 19, no. 12 (December). Available at www.ici.org/pdf/per19-12.pdf.

² Help in Defined Contribution Plans: 2006–2012 (Sunnyvale: Financial Engines and Aon Hewitt, 2013), page 33. Available at <https://corp.financialengines.com/employers/FinancialEngines-2014-Help-Report.pdf>.

³ Ibid, page 30.

⁴ Financial Engines independent analysis, derived from Help in Defined Contribution Plans: 2006–2012 (Sunnyvale: Financial Engines and Aon Hewitt, 2013).

⁵ Data from an unpublished Financial Engines 2015 analysis of prospect database reflecting over 11 million participants and \$908 billion in assets.

⁶ Financial Engines hired an outside firm to conduct in-depth interviews with 45 retirement plan consultants as part of a 2015 Consultant Perception Study. These interviews took place from June to August 2015.

⁷ “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012.” ICI Research Perspective 19, no. 12.

⁸ Cerulli, Retirement Markets 2015 – Growth Opportunities in Maturing Markets (Boston: Cerulli Retirement Markets, 2015), Chapter 1. <https://cerulli.com/vapi/public/getcerullifile?fileid=Foo067M>.

⁹ Financial Engines independent analysis, derived from Help in Defined Contribution Plans: 2006 – 2012 (Sunnyvale: Financial Engines and Aon Hewitt, 2013).

¹⁰ Ibid.

¹¹ Help in Defined Contribution Plans: 2006–2012, page 22; and, Jean A. Young, Target Date Fund Adoption in 2013, (Valley Forge, PA: The Vanguard Group, Inc., 2014) <https://institutional.vanguard.com/iam/pdf/TDFundAdoption13.pdf>.

¹² Aon Hewitt, 2015 Trends & Experience in Defined Contribution Plans, (Lincolnshire, IL: Aon Hewitt, 2015) <http://www.aon.com/attachments/human-capital-consulting/2015-trends-experience-dc-plans-highlights.pdf>.

¹³ Rebecca Moore, Plan Sponsor, February 5, 2016, “Managed Accounts Gaining Favor from Plan Sponsors” <http://www.plansponsor.com/Managed-Accounts-Gaining-Favor-from-Plan-Sponsors/>.

¹⁴ Cynthia A. Pagliaro and Stephen P. Utkus, The Value of Managed Account Advice (Valley Forge, PA: The Vanguard Group, Inc., 2015). <https://institutional.vanguard.com/iam/pdf/VMAPRES.pdf>.

¹⁵ Financial Engines hired an outside firm to conduct in-depth interviews with 45 retirement plan consultants as part of a 2015 Consultant Perception Study. These interviews took place from June to August 2015.

About Financial Engines

Financial Engines is America's largest independent investment advisor.* We help people make the most of their money by providing full-service financial planning, including professional investment management and advice. Headquartered in Sunnyvale, CA, Financial Engines was co-founded in 1996 by Nobel Prize-winning economist William F. Sharpe. We serve as a comprehensive financial advisor for our workplace customers, and offer help to more than nine million people across over 670 companies (including 143 of the Fortune 500) as of December 31, 2015. Our unique approach, combined with powerful online services, dedicated advisors and personal attention, promotes greater financial wellness and helps more Americans meet their financial goals.

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