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SELECTING A TARGET DATE FUND SERIES

Target Date Retirement Funds (TDFs) are one of the most widely used investment vehicles in 401(k) plans today, and for good reason. They are easy for participants to understand, and they provide asset allocation and regular rebalancing with little effort. According to the NEPC's 2023 DC Plan Trends and Fee Survey, 97% of plans offer TDFs, and on average, 47% of plan assets are invested in TDFs. However, not all TDFs are the same.

A Target Date Retirement Fund combines a mix of several different investment classes, typically stocks and bonds, that become more conservative over time as the retirement date approaches. They are typically offered in five-year increments, and employees select the appropriate fund based on their estimated retirement date. For example, someone who is currently 30 years old would select the 2060 Fund, while a 60-year-old may select the 2030 Fund.

So what factors should you consider when selecting a target date series for your plan?

GLIDE PATH

It is important to note that not all target date fund series start and end with the same equity exposure. The glide path adjusts the investment mix gradually over time, which in turn adjusts the risk in the fund. The investment risk is normally matched to a time horizon for the investments. For example, a 2065 fund has a longer time horizon and will have significantly more exposure to equity than a 2025 fund.

Different investment companies' target date fund series will have different glide paths. While one series may start with 95% equity in the 2070 fund, another series with a more conservative approach may start with 90% equity in its 2070 fund. This should be considered when deciding which target date series is most appropriate for your plan.

TO VS. THROUGH

Typically, a target date fund can be classified as "to" retirement or "through" retirement. A "to" retirement fund adjusts the asset allocation until the target date and then remains static. A "through" retirement fund continues to adjust the asset allocation (equity exposure) past the stated target date. So "to" funds reach their most conservative point at the target date, while a "through" fund will reach its most conservative point later.

DIVERSIFICATION

Diversification is typically seen as an important part of investing and helps to reduce risk. All target date funds will provide some exposure to equity and fixed income. However, they will differ in specific exposure to categories like US large cap, US mid cap, US small cap, international and emerging markets. Additionally, there are further categories under fixed income such as high yield, TIPS, and emerging markets debt. Finally, some target date funds will include non-traditional asset categories like Real Estate Investment Trusts (REITs) and commodities.

A target date series with sufficient diversification can help your participants' portfolio by combining a variety of investments and reducing risk and volatility over time.

ACTIVE VS. PASSIVE

Actively managed mutual funds are trying to outperform the applicable index, whereas passive or index funds are just trying to mimic the performance of an index. Passive tends to be lower cost. You can select TDFs using underlying funds that are active, passive or a combination of both. Active or passive will be closely tied to performance and fees when making your decision.

PERFORMANCE

This is the most obvious aspect to consider when choosing an investment. When comparing a target date fund series, you should compare and benchmark its investment performance to other leading companies.   For example, if you are considering Vanguard, it may be advisable to compare it to Fidelity and American Funds' offerings.

FEES

Fees are closely tied to performance and the two should be compared together. Over long periods of time, lower fees tend to maximize performance. The decision to go with actively managed funds versus passively managed funds will work into the fee discussion, as index funds are typically lower cost.

One of the biggest decisions you will need to make when constructing and monitoring a 401(k) Plan investment line up is which Target Date Fund Series to use. These six factors should help guide you to a well informed decision.

SUPER CATCH-UP

The SECURE Act 2.0 was a major piece of retirement plan legislation that was passed at the end of 2022 and introduced a wide range of changes to retirement plans. One of these changes is set to take place in 2025.

The IRS recently announced the contribution limits for 2025. The standard 401(k) contribution amount will be increased from $23,000 to $23,500, and the standard catch-up contribution will remain the same at $7,500. Therefore, if you are over 50 in 2025, you will be able to contribute up to $31,000.

However, starting in 2025, anyone who is age 60, 61, 62, or 63 is eligible for an increased catch-up contribution amount. This enhanced catch-up contribution limit is $10,000 or 150% of the standard age 50+ catch-up contribution limit, whichever is greater. The increased catch-up amount for 2025 has been set at $11,250. So, if you are age 60-63 you can contribute up to $34,750!

It is important to note that in the year that you turn 64 your catch-up amount reverts back to that $7,500.

This change has been dubbed the "Super Catch-Up" and it will allow those people who are closer to retirement more opportunity for savings and more opportunity for tax deferral.

Grimes has a dedicated team that specializes in providing investment advisory services to retirement plan fiduciaries and their employees. We assist clients with investment selection and monitoring, fee benchmarking, plan design and employee education.