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## Take Control of Your DC Plan: Designing Successful Target-Date Strategies

We've come a long way in the evolution of retirement investments, an evolution that started more than two decades ago with one-size-fits-all balanced strategies and the emergence of target-risk strategies (e.g., conservative, moderate and aggressive). More recently, the industry has overwhelmingly gravitated toward target-date strategies, which are geared toward the participant's expected time horizon to retirement rather than risk tolerance, and adjust their asset allocations automatically over time to become more conservative as the targeted retirement date approaches.

Passage of the Pension Protection Act of 2006 also added considerable momentum to the growth of target-date strategies in defined contribution (DC) plans. The legislation supports automatic enrollment programs using a Qualified Default Investment Alternative (QDIA), which includes target-date strategies among others. Today, nearly four out of five plan sponsors offer target-date strategies, with three-quarters of those using these strategies as their plan default.<sup>1</sup>

### Going Custom

While many mutual fund providers have stepped up with pre-packaged target-date funds, plan sponsors are increasingly deciding to create their own custom target-date strategies as a mix of their core investment options. There are several significant reasons for plan sponsors to develop a custom approach, including the control it gives over the investment lineup, the ability to tailor the asset allocation to the plan participants' demographics and a reduction in overall plan costs. Many plan sponsors particularly appreciate the ability to leverage core manager selection and monitoring, to blend investment structures and styles and to broaden asset diversification beyond the plan's core investment lineup.

Some plan sponsors may have the internal investment capabilities to create the dynamic asset allocation model, or "glide path," for custom target-date strategies. However, the majority of plan sponsors will likely need to engage the consultant community for advice and comprehensive support. Most consultants have developed the capability to design and modify the initial and ongoing glide path, as well as an ability to help determine the number of target-date strategies that should be offered, the array of underlying asset classes that should be employed and the time frame for rebalancing.

Indeed, the increasing prevalence of custom target-date strategies can be seen in the number of consultants offering these services. In a recent PIMCO survey of DC consultants, 90% said they offer custom strategy consulting and 82% can act as fiduciaries for custom services such as managing a plan's glide path.

### Building a Custom Strategy

While the potential benefits of custom strategies are clear, the work required to create them often is not. It is important to recognize that creating custom investment blends is not new; large plan sponsors have taken this approach in one asset category or more since DC plans' inception. Custom funds require the plan sponsor to address several issues:

- **Structuring, Developing and Monitoring Asset**

**Allocation:** By creating custom strategies, plan sponsors gain ultimate control in managing the glide path as well as the underlying core lineup. They are able to tap into investment options such as stable value and investment structures such as collective investment trusts (CITs) that are not accessible within packaged mutual funds. In an effort to enhance diversification and reduce volatility, plan sponsors may decide to add diversifying assets such as commodities, real estate or even less liquid alternatives into the custom strategies. Consultants can help a plan sponsor determine the number of strategies the plan may want to offer, the sufficiency and appropriateness of core investments, the initial and ongoing asset allocation or glide path and the rebalancing time frames. The plan sponsor may employ the consultant to act as a fiduciary, or even as a discretionary investment manager.

- **Establishing and Maintaining Operations:**

Custom target-date strategies are relatively

simple to set up from an administrative perspective. These strategies employ a similar approach as blended-manager institutional core strategies, which have been supported by record keepers and trustees for decades. There are two basic ways in which target-date strategies can be set up:

- **Model Portfolio Approach** (some may call this the "paper portfolio" approach) – a record-keeping system solution where the plan administrator creates a set of model target-date portfolios using all or a portion of the core funds.
- **Trust Unitization Approach** (some may call this the "custodial model" approach) – a trust *and* record-keeping system solution where each target-date portfolio is set up as a separate account within the trust and as an individual investment option on the record-keeping system, using all or a portion of the core funds. This approach also offers the option to include investment strategies outside of the core fund lineup.

Some record-keeping providers offer a combination of these two approaches where, for example, the investment and rebalancing tasks normally provided by the trust are performed by the record keeper. Exploring with your record keeper the approaches they support is an important step in designing the custom target-date strategies that you envision.

- **Designing Participant Education and**

**Communication:** Communication requirements for custom strategies are similar to the requirements for other institutional options, including separately managed accounts and collective investment trusts. Communications at a high level should start by helping determine whether the target-date

strategy is the best option for a particular participant. The communication should clearly lay out the choices and then provide opportunities for participants to dig deeper into the specifics of each strategy, including the underlying investment details and risk factors. The goal is to guide employees to the option that best meets their needs, and to ensure alignment as appropriate with the final QDIA regulations, Employee Retirement Security Act (ERISA) Section 404(c) and form S-8 disclosure requirements. Successful communication plans may include a mixture of written, Web, phone and in-person support.

- **Considering Cost Implications:** Investment consultants believe many plans can reduce expenses by creating custom target-date strategies using the plans' own institutional core strategies. Consultants and plan sponsors have estimated the net savings especially for larger plans to be between 20% and 65% relative to using packaged target-date funds. However, each plan is different and has to do a full analysis of its own costs, taking into account fees for consulting, record keeping, trustee services, communications, legal support and the cost of staff who are dedicated to the project. Plan sponsors should also consider whether they want to encourage plan participants to remain invested in the plan even after termination or at retirement, which may result in significant additional assets, and can in turn reduce the overall plan cost.
- **Addressing Legal Issues:** As with other plan investment options, custom target-date strategies require legal support to ensure regulatory, fiduciary and structural considerations are met. In addition to ensuring compliance with plan guidelines and the law, specialized legal professionals may be needed

to review the implications of regulatory requirements and safe harbor rules for asset allocation, and to review plan documents.

Custom target-date strategies make sense for many organizations, especially for midsize and large plans that desire optimal asset management control and have the buying power to lower plan costs. As plan assets grow, the value of a custom approach becomes more critical. While custom strategies are a relatively recent development in comparison with balanced or target-risk funds, the operations and supporting communication methods are not. DC plans have for decades created blended manager options and communicated about these investment blends.

Plans that are interested in developing target-date strategies do not have to go it alone. A range of services from investment managers and consultants are available, and plans can choose the exact degree of third party services that are needed to complement the plan sponsor's in-house capabilities. By creating custom target-date strategies, plan sponsors can make retirement investments that are lower in cost, have the potential to be more diversified, follow a more optimal glide path and are tailored to the demographics of plan participants. The ultimate goal is a higher probability of meeting your plan participants' retirement income needs.

**To learn more about target-date strategies and the experts who can help you create them, please go to [www.customtarget.net](http://www.customtarget.net). This site offers videos with the experts as well as an introduction to *Designing Successful Target-Date Strategies for Defined Contribution Plans*, a recent book authored by Stacy L. Schaus, CFP®.**

**If you have questions, please contact your PIMCO representative, or email us at [pimcodcpractice@pimco.com](mailto:pimcodcpractice@pimco.com). We're interested in your ideas and feedback!**

<sup>1</sup> Source: Casey Quirk/PSCA Survey, June 2009

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