Custom vs. Off-the-Shelf Lifecycle Funds

By Michael Kaplan

There is increased interest, especially by larger employers around the globe, in custom lifecycle funds. A plan sponsor's custom lifecycle fund uses a combination of the plan's core funds, thus ensuring that the same group of funds is offered to all participants. When selecting to invest in a plan's off-the-shelf lifecycle product, participants may not have access to all the same funds that the employer has selected and monitors. While the employer does select and monitor the off-the-shelf fund, the investment manager controls the selection of underlying funds, which in most cases is limited to a proprietary family of funds. This arrangement has three disadvantages:

Employee communications. A second set of funds needs to be communicated to participants, along with the employer's reasons for not making the same underlying funds available to all participants.

Performance and diversification. If the underlying funds are all from the manager's proprietary fund family, this may limit diversification and may preclude a lineup that meets the sponsor's investment policy standards.

Monitoring. Effectively monitoring all the underlying funds within the lifecycle fund, in addition to the core lineup, can place a strain on resources. Further, if issues are found in one of the underlying funds, the sponsor cannot make changes.

A customized approach also provides the opportunity to include higher-risk and alternative asset classes in a lifecycle vehicle. This can be more appropriate than having these asset classes as stand-alone options. The risk of higher-risk asset classes can be minimized since the lifecycle vehicle will be highly diversified.

Although many plan sponsors are moving to a customized approach for the reasons mentioned above, other considerations may lead a plan sponsor to select an off-the-shelf product:

Cost. Plan sponsors should consider the additional costs associated with creating and managing a custom lifecycle-funds program compared to an off-the-shelf product. Plans of sufficient size can construct lifecycle funds using separate and commingled accounts rather than mutual funds. The use of these vehicles may offset some or all of these costs through lower investment management fees. Such costs include:
- custody fees for creating a daily net asset value representing the values of the underlying funds and for allocating cash flows and rebalancing assets in accordance with the asset allocation strategy
- consulting fees for developing and updating the asset allocation strategy
- fees for customized employee communications

Fiduciary risk. The plan sponsor needs to develop the asset allocation and rollover strategy (resetting the target asset allocation over time by shifting assets out of stocks and into bonds and cash), thus opening the door for criticism if they turn out to be unsuccessful.

Underlying Strategy—Actively Managed vs. Indexed

Where creating custom lifecycle funds from core investment options is desirable but perhaps unpractical for the above reasons, some plan sponsors are turning to indexed or passive off-the-shelf lifecycle funds. In fact, even where custom funds are feasible, the plan sponsor may prefer an indexed strategy.

This approach mitigates the issue of the underlying funds differing from the core options. Although the underlying funds would still differ, investment risk and the monitoring resources required are substantially smaller than with actively managed funds. In addition, participants who prefer lifecycle investing may also prefer indexed strategies. Lifecycle investors seek to minimize their active involvement (e.g., rebalancing or monitoring performance). Finally, with index funds, there is minimal risk of style drift or underperformance due to active management decisions.

On the other hand, indexed lifecycle funds do have disadvantages. Participants choosing these funds do not benefit from active management, which can outperform passive investing. In fact, fund expenses ensure passive lifecycle funds will always underperform the benchmark on a net-of-fee basis. Also, it may be difficult to obtain exposures to asset classes that can offer diversification benefits but are not easily indexed, such as real estate or infrastructure.

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