

Commco Comments

Timely Information and Updates for Employers and Retirement Plan Sponsors

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*Name one advantage
each of both active and
passive TDFs.*

Target Date Portfolios: Active vs. Passive Management

Target date funds (TDFs) have become the undisputed cornerstone of modern 401(k) plans. As the default investment option (Qualified Default Investment Alternative or QDIA) for most employer-sponsored retirement plans, TDFs handle the heavy lifting for participants by automatically adjusting their asset allocation from growth-focused toward conservative as retirement approaches.

For plan sponsors who have decided to include target date funds in their plan's investment menu, one detail remains: should your plan offer an actively managed or passively managed target date portfolio suite, or both? Both investment philosophies bring distinct strengths and tradeoffs to the table. Understanding their nuances is key to optimizing your plan lineup and supporting your employees' financial wellness.

Passive Management: Simplicity and Cost-Efficiency

Passively managed target date funds build their portfolios using index-tracking funds (such as an S&P 500 index fund or a total bond market index fund). The goal is simple: mirror the performance of specific market benchmarks rather than trying to beat them.

Key Features of Passive TDFs

- Lower expense ratios: Because index funds require less hands-on management and research overhead, passive TDFs can boast significantly lower fees. Lower fees mean more of the participant's money stays invested and compounds over time.
- Predictable benchmark tracking: Passive funds function exactly as their fund fact sheet describes. Participants get broad market exposure without the risk of individual manager underperformance.
- Ease of communication: For HR teams, explaining passive index investment strategy to employees is straightforward, transparent, and easy to understand.
- The tradeoff: Passive funds will never outperform the market index. During market downturns, a passive fund simply tracks the decline of its underlying benchmarks without adjusting cash levels or shifting into defensive sectors.



Active Management: Flexibility and Tactical Opportunities

Actively managed target date funds rely on professional portfolio managers and research teams who actively select underlying stocks, bonds, and specialized asset classes. These managers make strategic and tactical adjustments based on economic trends, market valuation, and risk forecasts.

Key Features of Active TDFs

- Downside protection and risk management: Active managers have the flexibility to reduce exposure to overvalued market sectors or increase cash holdings during periods of heightened volatility. This can provide crucial cushion for employees nearing retirement.
- Access to specialized asset classes: Managers may incorporate asset classes that are harder to index efficiently – such as high-yield debt, emerging market debt, infrastructure, or real estate – potentially boosting risk-adjusted returns.



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Target retirement date (lifecycle) investment options are designed for participants who plan to withdraw the value of their accounts gradually after retirement. Each of these options follows its own asset allocation path ("glidepath") to progressively reduce its equity exposure and become more conservative over time. Options may not reach their most conservative allocation until after their target date. Investors should consider their own personal risk tolerance, circumstances, and financial situation. This information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Raymond James and its advisors do not offer tax or legal advice. You should discuss any tax or legal matters with the appropriate professional. You should discuss any tax or legal matters with the appropriate professional.

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- Opportunity for outperformance: Active TDFs aim to outperform broad market benchmarks, offering participants the potential for higher net returns over long market cycles if the manager succeeds.
- The tradeoff: Active management requires extensive research and trading, leading to higher overall expense ratios. Additionally, active management introduces "manager risk," which is the possibility that market timing or security selection decisions cause the portfolio to underperform its benchmark.

Next Steps: Reviewing Your Plan Strategy

So, which option is right for your 401(k) plan? The answer isn't one-size-fits-all. Every organization brings a unique combination of participant demographics, fee sensitivity, investment philosophy, and retirement goals. In addition, different target date portfolio suites might be offered or incentivized depending on the plan's recordkeeper, which could tip the scales from a whole-plan perspective.

Offering a single solution isn't the only path forward. Depending on your recordkeeper's platform capabilities, some plans choose to offer a passive series as the plan's QDIA while providing active options within the broader lineup (or vice versa), allowing participants flexibility based on their individual preference and market conditions. However, some plans may decide that the potential confusion created by a more complex fund menu is not in the best interests of their employee population.

Fiduciary Perspective

As a plan sponsor, your key question is not simply "active or passive?" but "Which target date series is most appropriate for our participant population, after considering fees, glide path, risk level, manager quality, and participant outcomes?" ERISA does not require the lowest-cost option; it requires a prudent process for selection and monitoring.

The best path forward is to review the options with your financial advisor as part of your regular annual or semi-annual retirement plan review. Together, you can examine your specific workforce demographics, review current glide paths and fee structures, and determine whether active, passive, or a combination approach best serves your employees' path to retirement readiness.