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Employee Benefit Plan Review

Are BlackRock's Target Date Funds the New Fiduciary Battlefield?

By Gary D. Blachman

Nearly a dozen lawsuits have been filed recently against some of the largest 401(k) plan sponsors in the industry. These lawsuits alleged fiduciary violations when plan sponsors selected certain low cost target date funds that underperformed compared to other target date funds. This latest wave of lawsuits is just another phase in the ongoing war against large plan fiduciaries. Plaintiffs' claims in these lawsuits include virtually identical allegations under the Employee Retirement Income Security Act of 1974 (ERISA) and, specifically, that the BlackRock LifePath Index target date funds (BlackRock TDFs) have had consistently lower returns than the more popular and best performing, actively managed target date funds (TDFs).

These new allegations are a creative twist on the types of fiduciary allegations that were litigated over the last several decades and commonly referred to as "excessive fee" lawsuits. In most of those previously filed cases, the defendants were accused of permitting plan participants to incur excessive fees and failing to leverage their institutional bargaining power to obtain less expensive share classes and lower recordkeeping expenses from investment advisors and other plan service providers. In those cases, plan fiduciaries were alleged to have selected investment fund options which were both overpriced and poorly performing relative to their higher investment management fees (as compared to passively managed funds), and therefore, should be removed from the plans' investment lineup. Additionally, those cases often claimed that actively managed investment options generally failed to justify the higher overall fees when compared to lower fee and better performing index funds. As a result of those lawsuits, many plan sponsors changed their practices and selected less expensive TDFs to limit their ongoing risk of litigation.

However, in contrast, this new wave of lawsuits focuses on the alleged underperformance of certain TDFs that many plan sponsors use as their plan's default investment option. In these most recent cases, each of the defendants offered the Blackrock TDFs, a suite of ten passively managed TDFs, as the default investments in their defined contribution retirement plans. These new lawsuits allege that investment returns were sacrificed in favor of plan sponsors chasing low fees. The claims are essentially that the BlackRock TDFs are inappropriate for institutional plans and that fiduciaries were not prudent in selecting these lower cost investment options. Where the "excessive fee" litigation cases alleged that plan sponsors' processes were deficient due to a lack of benchmarking to find lower fee investment options, these latest cases do not even allege any concerns with the plans' selection processes. Essentially, the plaintiffs target plan sponsors responsible for overseeing

company retirement plans as having retained the BlackRock TDFs when better performing investments were available and could have been selected.

The defendants in these cases include many well known national employers such as Capital One Financial Corp., Citigroup, Inc., Wintrust Financial Corp., Stanley Black & Decker, Inc., Booz Allen Hamilton, Inc., Genworth, Marsh & McLennan, Advance Publications and Cisco. Most of the defendants have over $500 million in assets in their retirement plans.

Nearly all of the complaints contain mirror allegations "that defendants failed to scrutinize the performance of the Blackrock TDFs against any of the more appropriate alternatives in the TDF marketplace in order to determine whether the expected performance of the Blackrock TDFs could support their continued retention in the plan." The lawsuit filed by Citigroup employees claims that "defendants selected, retained, and/or otherwise ratified poorly-performing investments instead of offering more prudent alternative investments that were readily available."

Target Date Funds: Let's Set It and Forget It

A traditional TDF is an investment option that automatically shifts its asset allocation from higher to lower risk as the investor nears his or her anticipated retirement year. The asset allocation glide path begins with the majority of the TDF being invested in equities, and as the retirement date approaches, that equity allocation decreases and the allocation in fixed income investments increases. Generally, the funds are designed to build gains in the early years by focusing on riskier growth stocks, and then they aim to retain those gains by shifting the internal fund weighting towards safer, more conservative choices as the target date approaches. Typically, the goal is to provide cash at the end of the predetermined time period.

TDFs are highly valued by plan participants for their convenience and ability to place their TDFs on autopilot and essentially "set it and forget it" for much of the fund's existence. TDFs are generally viewed as safe investments, and they are often used by 401(k) plans and other retirement vehicles as their default investment option. TDFs with a "to retirement" philosophy reach their lowest risk asset allocation upon reaching the investor's year of retirement, and a "through retirement" TDF continues to lower its risk allocation for 10 to 15 years after the investor reaches retirement age. The thinking with a "through retirement" glidepath is that participants may have some risk tolerance after retirement to seek potential higher returns in the years after they retire especially since participants on average are living longer and have a longer investment horizon.

The "Cookie Cutter" Lawsuits

In these most recent lawsuits, plaintiffs alleged that BlackRock TDFs underperformed other mutual fund TDF alternatives during the period 2016 to 2021. The plaintiffs presented numerous performance data which was claimed to track performance of BlackRock TDFs against comparative funds for these time periods.

Each of the 401(k) plans involved in the lawsuits offered the BlackRock TDFs, which received the highest rating in the Morningstar 2022 Target-Date Landscape report. Despite this rating and the fact that TDFs are not meant to have the best performance of a 401(k) plan's investment options, the plaintiffs argue that plan fiduciaries failed to consider the BlackRock TDFs' return potential and instead only "chased the low fees" charged by the funds. The complaints allege the plans' investments in BlackRock TDFs resulted in participants "missing out on millions of dollars in retirement savings growth" that could have been realized with investments in other better performing TDFs.

To illustrate the BlackRock TDFs' alleged underperformance, the plaintiffs compared the BlackRock TDFs' returns with a series of other funds that included Vanguard Target Retirement Fund, T. Rowe Price Retirement Fund, Fidelity Freedom Fund, Fidelity Freedom Index Fund, and American Funds Target Date Retirement Fund. However, the five least expensive share classes from each of these funds all received high industry ratings. The American Funds Target Date Retirement and the T. Rowe Price Retirement both earned Morningstar Analyst Gold Ratings and the others were each Silver rated.

However, plaintiffs did not appropriately compare BlackRock TDFs to similar funds or managers. The funds used by plaintiffs are not comparable to the BlackRock TDFs for two reasons:

- *Glide Path*. The TDFs selected by the plaintiffs for comparison are "through retirement" funds, while the BlackRock TDFs are "to retirement" funds. Because the TDFs selected by plaintiffs are "through retirement" funds, they have a higher exposure to equities closer to a participant's retirement date (i.e., age 65), whereas, the Blackrock TDFs have less equity exposure closer to a participant's target retirement date. Blackrock's so-called underperformance as compared to the five "peers" selected in each of the complaints is due to its investment strategy of using this lower allocation to stocks. And, despite any perceived underperformance, the Blackrock TDFs are still leading the category average over the time period.
- *Active Versus Passive Management*. The BlackRock

TDFs are "passively managed" funds designed to track the market through investments in index funds rather than attempt to outperform the market as "actively managed" funds are designed to do. The TDFs selected by plaintiffs as "comparators" were higher performing actively managed funds, while the BlackRock TDFs are made up of passively managed underlying funds.

Generally, actively managed funds tend to outperform during bullish markets due to the higher level of equities available for investment. Passive funds are instead designed to provide an investment option that is more resistant to market fluctuations. Due to their structure, actively managed funds are typically more expensive than passively managed TDFs.

QDIAS Under Fire

Plaintiffs' complaints also alleged that using the BlackRock TDFs as a qualified default investment alternative (QDIA) was imprudent and a breach of fiduciary duty. A QDIA is an investment in which a participant's assets are invested by "default" if they do not specify how they want their assets invested. However, the complaints did not include a comparison to meaningful benchmark of investments with the same objectives and strategy. Further, plaintiffs' allegations do not point to a drastic level of underperformance over the long term that a prudent fiduciary who was monitoring such performance should have realized in order to take corrective action. Instead, plaintiffs allege the Blackrock TDFs should be compared to the six largest TDF series in the market because "they represent the most likely alternatives from which to replace the BlackRock index TDFs." This suggested strategy however, appears to create an inconsistent argument that ignores the consideration of investment mix and strategy by comparing funds with distinctly different investment objectives.

What Should Plan Fiduciaries Do Now?

Over the past decade, those TDFs that followed a more aggressive "through retirement" strategy tended to outperform their peers as equities continued to produce greater returns in an up-market. However, only through the benefit of hindsight is it now apparent that this approach produced more positive returns. In contrast, during down market cycles a "to retirement" philosophy actually benefited participants. As recently as 2022, BlackRock's TDFs provided much smaller losses when compared to the other peer funds named by plaintiffs.

A comparison of the BlackRock TDF "to retirement" strategy to a "through retirement" glidepath is not appropriate due to their inherently different investment strategies. To hold plan sponsors accountable for providing less risky investment options as participants near retirement should not be faulted from a fiduciary perspective. Further, doing so would create an entirely new standard for plan sponsors and fiduciaries.

Plan fiduciaries do not have a responsibility under ERISA to select the best performing investment options or the least expensive options. However, plan fiduciaries should conduct a thorough evaluation and selection process for making these decisions. Additionally, plan sponsors should be certain to carefully document all investment selection decisions as part of their best practices. At the end of the day, plan sponsors should not have to worry whether every fund in their core investment line up is a top performer during all market cycles.

Plaintiffs' claims have yet to wind through the motion phase. Hopefully, defendant corporations will continue to challenge this type of lawsuit and not merely settle to avoid the cost of litigation. If defendants can prevent these cases from moving past a motion to dismiss that may discourage similar cases that appear to lack sufficient proof of investment underperformance and fiduciary imprudence.

In the meantime, plan sponsors can take action by solidifying their administrative practices when deciding what investments to offer plan participants. Plan sponsors should not assume that selecting the lowest cost funds will alone protect them from liability. With plaintiffs constantly innovating and finding creative ways to challenge investment decisions, it is important to have a detailed administrative process for selecting and monitoring plan investments as well as process for accurately documenting these fiduciary decisions. The best defense against these lawsuits is having a detailed system of plan governance and prudent processes in place to select investment fund options and QDIAs for retirement plans. ❂

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