Target-Date Funds:
It's Time to Take a Closer Look

Executive summary

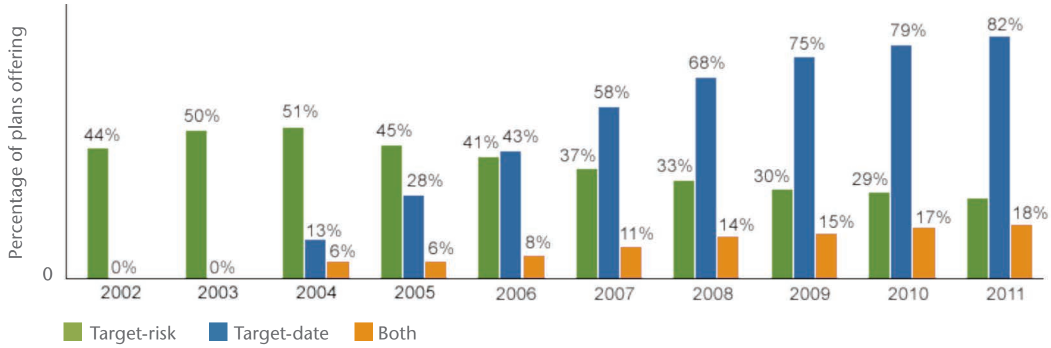
Over the past few years, retirement plans have seen significant changes in their investment structures, as well as the level of fiduciary liability and risk for plan sponsors. One of the biggest areas of growth is target-date funds.

Target-date funds were initially created as simplified investment options. After participants select the fund, there's no need for them to change allocations over time. In other words, **the funds are essentially "set-it-and-forget-it" options.** This is easier for participants. However, participants who elect target-date funds are placing **greater responsibility on the plan sponsors** to help them achieve retirement success.

In 2007, the Department of Labor ("DOL") issued regulations regarding Qualified Default Investment Alternatives (QDIAs). A QDIA is an investment option that participants will automatically default contributions into unless they elect to direct their contributions elsewhere.

The rules said a QDIA should be a "product with a mix of investments that takes into account the individual's age or retirement date" (ERISA, 2007). As a result, the **use of target-date funds skyrocketed** *(see Figure 1 below).*

Figure 1



Source: "How America Saves 2012", Vanguard, 2012

This rapid **growth in the number and use of target-date funds creates the need for additional scrutiny and analysis on the part of plan sponsors.** Given the rise of open architecture (the ability to select investments not managed by the recordkeeper) within defined contribution plans, plan sponsors should carefully consider which fund series would best suit the needs of their participant group as a whole. This **additional analysis will benefit the participants and help to limit liability on the part of the plan sponsor.**

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How do target-date funds work?

Target-date funds automatically shift asset class allocations based on the retirement year of the fund. Funds with retirement years further away from the current year (2035, 2040, 2045 funds) will have heavy equity exposure—usually around 90% of assets.

As the fund nears the target retirement year, the equity exposure begins to shrink. At the same time, the fixed income exposure increases until a fixed level at or near retirement is achieved.

A typical target-date fund is composed primarily of the various mutual funds managed by the firm, although there could be other types of holdings like exchange-traded funds (ETFs) or individual securities. These miscellaneous holdings could include cash, treasury securities, individual bonds, options, or real assets, all with the overall goal of creating a well-diversified investment vehicle.

Target-date options vs. core investment options

Target-date funds are quite different from core investment options such as large cap, small cap, or intermediate-term bond funds. As a result, it's important to evaluate target-date funds differently than core options.

	Target-date options	Core options
Intended users	"Do it for me."	"Do it myself."
Fiduciary burden on plan sponsor	Greater when used as the QDIA	Reduced responsibility because participants manage their own investments
Returns and asset allocation	Returns will vary significantly based on the different asset allocations between funds	Returns affected by security selection, sector allocations, and asset class allocations
Return data usage	If < 5 years of data, while approached with caution, can still be analyzed via a thorough review of the underlying funds since they likely have longer track records than the target-date funds themselves	Funds with < 5-year track record are generally avoided

INTENDED USERS

Target-date funds were initially created for passive participants. **Participants who default to target-date funds are likely to:**

- **Be overwhelmed by the many options offered to them by their plan**
- **Have limited investment knowledge**
- **Be unaware that they have the option to direct their contributions**

With the ever-increasing number of fund choices and growing uncertainty and volatility in the marketplace, many investors and participants are growing more and more confused about how to effectively manage their retirement accounts.

The volatility and uncertainty in the markets may cause many participants to make emotionally charged changes to their accounts, which could result in a negative impact on their accounts in the future. Target-date funds help take the emotion out of investing.

BURDEN ON PLAN SPONSOR

Participants defaulting into the QDIA option in their retirement plan are essentially placing greater trust and responsibility in the hands of the plan sponsor for the success of their retirement account. This doesn't mean that the plan sponsors are responsible for selecting the most optimal investment option for the plan. Rather, the plan sponsors are expected to select the most optimal default investment option.

Participants who actively manage their accounts adjust their allocations to various asset classes on their own. Underperformance in their accounts can often be attributed to this active management. If a participant's retirement account is underperforming that of his or her peers, the varying asset allocations may be partly to blame—not solely poor fund selection by the plan sponsor.

ASSET ALLOCATION AND RETURNS

The returns of core investment options are often affected by security selection, sector allocations, and asset class allocations. The returns of target-date funds, however, will vary significantly based primarily on the different asset allocations between funds.

Individual mutual funds are already relatively diversified in terms of holdings. **As target-date funds predominantly consist of multiple mutual funds, most of the selection risk is diversified away because of this large number of holdings.** In periods when equities exhibit solid performance, equity-heavy funds will far outperform more conservatively allocated funds. The opposite is true when equities have low or negative returns in a period where fixed income returns outperform equities.

RETURN DATA USAGE

As target-date funds are a relatively new trend in retirement plans, there may be a number of funds that don't have a full five or 10 years of return data. In the world of mutual funds, those with less than five years of data would tend to be avoided or viewed with much caution, and those with less than a three-year track record are generally avoided. The lack of data doesn't paint a full picture of the effectiveness of the fund manager's strategy and style.

However, this may not always be the case with target-date funds. More likely than not, **the underlying mutual funds within a target-date fund have a longer track record** even though the target-date fund itself is relatively new. Despite this, analyzing target-date funds with less than five years of data should still be approached with caution.

Selecting the optimal target-date fund series

UNDERSTANDING PARTICIPANTS

Before performing a manager search to identify which target-date fund series is the most optimal for the plan, it's important to **first establish the needs and objectives of the plan.** This begins with an evaluation of those the plan is intended to serve – the participants.

A good place to start is the demographics of participants. Plan sponsors should consider the following questions:

- [ ] **What is the average age of the participants?** For an overall younger workforce relative to peers, a more aggressively allocated fund may be more appropriate. A more conservative fund series may be ideal for an older workforce.

- [ ] **What is their average life expectancy?** Studies have shown that there are distinct variations in the life expectancy of participants depending on the industry and work environment. In an industry in which participants are likely to live longer than the average participant, the plan may need to limit their associated longevity risk because participants may have a greater risk of outliving their retirement savings.

- [ ] **What is the average compensation level of participants?** Participants with lower-than-average salaries may:
    - — Rely significantly more on their employer's retirement plan than higher-income participants
    - — May not be able to bear as much of a large loss to their accounts (so the plan may need to offer target-date funds with more downside protection)
    - — Feel a bigger impact from potential Social Security cuts in the future

- [ ] **How knowledgeable are participants about investments and finance?** Participants with little investment expertise may be better off with a target-date fund.

“To” vs. “through”

Target-date funds can be separated into two groups of funds in terms of their glide path style:

1. **Those that manage the fund’s asset allocations “to” retirement** continue to shift asset allocations as they near retirement but freeze asset allocations at fixed percentages once they reach their target retirement year.
2. **Those that do so “through” retirement** continue to manage asset allocations after reaching the target retirement year and continue to do so until asset allocations freeze at a fixed percentage 15 to 20 years post the retirement date

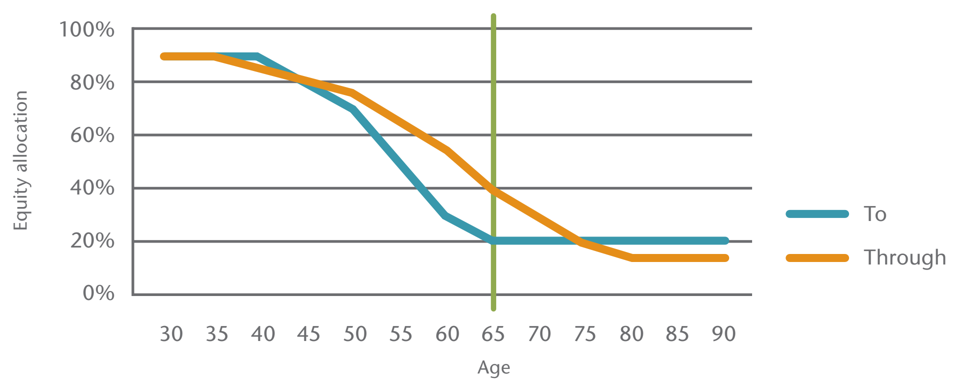
For participants in their early years (i.e., funds with target retirement years past 2035), the target-date fund allocations tend to look relatively similar – equity exposure around 90% of assets. The glide paths of “to” and “through” funds begin to diverge as the funds reach their target retirement years (i.e., 2015 or 2020 funds).

“To” series target-date funds will typically begin to approach their final asset allocations much more quickly as they approach retirement. At that point, participants are usually transferred to a retirement income fund with a relatively low equity exposure.

Conversely, “through” series funds tend to assume a more gradual glide path as they approach the target retirement year. Then the glide path continues to shift to a minimal equity exposure about 15-20 years after retirement.

Figure 2 illustrates how the “to” and “through” glide paths may differ from each other.

Figure 2 **“TO” AND “THROUGH” GLIDE PATH**



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The choice between implementing a “to” or “through” target-date fund style lies in the needs of the participants and the objectives of the plan.

The most common issue in making this selection is the tradeoff between longevity risk and market risk.

- **Longevity risk** is described as the risk of participants outliving their retirement savings, which can cause participants to run out of savings near the end of their lives.
- **Market risk** is the risk of loss associated with investing in the financial markets.

Fund series following a “to” glide path style tend to carry more longevity risk and less market risk as savings are presumed to be built only up to the retirement year. Fund series following a “through” style tend to exhibit more market risk and less longevity risk. These funds continue to save in their accounts a number of years into retirement while also receiving payouts from their accounts.

This leads to a higher equity exposure at retirement and the years following, which creates the potential for greater market risk. Plan sponsors must consider the pros and cons of both types of styles in order to determine which will most effectively help participants to achieve a dignified retirement.

GLIDE PATH

The glide path construction of target-date funds is one of the most striking differences between any two funds. No two glide paths are the same, and they will ultimately determine the fund’s risk exposure and expected potential returns. There is no universal “best” glide path, so plan sponsors must determine which target-date fund series would most effectively help the participants achieve retirement success.

The best way to evaluate the glide path of a fund is by asking the following questions:

- What are the maximum and minimum equity exposures of the fund, and how does the equity allocation shift as the fund approaches the target retirement year?
- How do the asset allocations vary between funds for domestic equity, international equity, fixed income and cash?
- Does the fund consists only of traditional assets (i.e., stocks, bonds and cash), or does it also include alternative assets such as commodities, high yield bonds, emerging markets and real estate, among others?
- How well is the fund diversified in terms of the number of different asset classes and the number of different funds within those asset classes?

These questions help to understand the overall composition of the funds. Identifying the differences between funds helps to determine the *expected* risk/return profile of the funds and compare it to the *actual* risk/return profile.

Unexplainable deviations from expectations, good or bad, should be viewed with scrutiny. This may indicate an issue with the management of individual accounts. Combining the glide path analysis with a quantitative analysis, which is explained in the following section, is an effective method in determining the optimal target-date series for a given retirement plan.

QUANTITATIVE ANALYSIS

As mentioned above, plan sponsors are expected to select the most optimal *default* investment option for their participants in regard to their QDIA offering. Does this mean they are to select the fund with greatest expected returns over the long-term? Not necessarily. A fund with greatest expected returns would be expected to exhibit the greatest risk.

So should the plan sponsor just select the fund with the lowest volatility or risk? No, because then participants are provided with low expected returns.

When assessing what the optimal *default* investment option should be, the question plan sponsors should ask themselves is this:

"What target-date fund series can be expected to provide the best possible outcome for all types of participants retiring in any cycle of the economy?"

In answering this question, the optimal risk/return profile needs to be considered. This **should not only be examined from a qualitative perspective but should also be viewed quantitatively** in order to understand the fund's performance with respect to its asset allocations and glide path.

Analysis benefits plan sponsors and participants

The importance of—and reliance on—target-date funds within defined contribution plans is skyrocketing. Early adopters of target-date funds often used their recordkeepers' target-date fund and didn't perform a careful analysis of other options.

With the advent of additional target-date options and increased market competitiveness, however, plan sponsors have a fiduciary duty to take a closer look.

A thorough analysis of target-date funds will provide solid fiduciary documentation—and help plan sponsors offer the most appropriate target-date fund for their participants.

PlanPilot, LLC ("PlanPilot") is a retirement plan consulting firm structured on the foundation of serving plan sponsors and has a significant commitment to serving the defined contribution marketplace. With increasing regulations on retirement plans, we believe that the most effective and optimal method of helping our clients is through specialization of services. In addition, by working with professionals who are committed to the niche of employee benefit programs, the level of service and the quality of the deliverables is heightened.

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*We would be happy to answer any questions you may have and can be contacted at **info@planpilot.com** or **(312) 973-4911**.*
