Not All Target-Date Portfolios Are Created Equal

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"Specifically, at any point in time employees are likely to do whatever requires the least current effort: employees often follow the 'path of least resistance.' Almost always, the easiest thing to do is nothing whatsoever, a phenomenon that we call 'passive decision.' Such passive decision-making implies that employers have a great deal of influence over the savings outcomes of their employees. For example, employer choices of default savings rates and default investment funds strongly influence employee savings levels. Even though employees have the opportunity to opt out of such defaults, few actually do so."

- "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance" by James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick; Tax Policy and the Economy, November 9, 2001

Participant inertia and the advent of automatic defined contribution plan features

In the past decade, the number of defined benefit plans has declined drastically, with the result being that defined contribution (DC) plans have come to represent the most important component of most American workers' retirement security. DC plans were designed to provide participants with the opportunity to manage their own retirement savings and investments. However, studies of defined contribution plan participants have repeatedly shown that they tend to make decisions based on too little information or simply become paralyzed and refrain from decision-making at all, resulting in inaction. Plan sponsors have battled this inertia, confusion, and avoidance, struggling to help employees save and invest wisely for retirement. In an effort to improve the success of DC plans in providing for a secure retirement, the industry has worked hard to address these issues and provide viable solutions.

"There is a worldwide trend, in both the public and private sectors, away from defined benefit (DB) retirement plans toward defined contribution (DC) plans. DC plans transfer much of the decision making authority about how much to save and how to invest from the employer or government to the employee. It is rare to find someone who has spent much time determining the optimal savings rate, given all the uncertainties about future rates of return, income flows, retirement plans, health, and so forth. Instead, most people attempt to cope with complexity by adopting simple heuristics, or rules of thumb, to aid decision-making. Simple heuristics often lead to counterproductive biases, however.... What becomes apparent is the overwhelming power of inertia..."

- "The Behavioral Economics of Retirement Savings Behavior" by Richard H. Thaler and Shlomo Benartzi; AARP Public Policy Institute, January 2007

In recent years, the focus in the DC industry has been on how to assist participants in making choices that will serve their long-term interests. Knowing that the tendency is toward low (or no) savings rates and poor allocation decisions, energy has been directed toward developing automatic features such as automatic enrollment, automatic contribution increases, and default or one-stop-shopping investment choices. With the Pension Protection Act of 2006, automatic options became easier for plan sponsors to implement by providing legislative support and establishing qualified default investment alternatives (QDIAs).

Research suggests that the industry is moving in the right direction with automatic plan features. A recent study by the Vanguard Center for Retirement Research found that automatic enrollment had a significant effect on initial enrollment and participation rates: "The impact of automatic enrollment is quite striking. Under automatic enrollment, the plan participation rate for new hires was 86%.... By comparison, only 45% of employees hired under voluntary enrollment join their 401(k) plan, with 55% failing to join." (Nessmith, Utkus, Young, 2007) According to the same study, automatic contribution increases shared a similar success. "Automatic annual savings rate increases have a beneficial effect on the total contribution rate. After five years, the number of employees at a 1% to 8% total contribution rate falls, from 50% of automatically enrolled participants to 19%. There is a corresponding jump in the number with total contributions in the 9% to 12% range, and of those with rates higher than 12%." (Nessmith, Utkus, Young, 2007)

"The vast majority of participants choose a small number of funds, with the median between three and four funds, and there is a strong tendency to divide assets equally among the funds chosen."

- "The Behavioral Economics of Retirement Savings Behavior" by Richard H. Thaler and Shlomo Benartzi; AARP Public Policy Institute, January 2007

Asset allocation was the next logical frontier for automatic features. Even with education, participants tend to make naive and/or emotional choices when creating an investment strategy, resulting in an asset allocation that is less than optimal. Risk-based lifestyle portfolios, target-date portfolios, and managed portfolios have offered potential ways to address this challenge. Final qualified default investment alternatives regulations cemented each of these solidly as viable options for plan sponsors. Target-date funds, which provide a cost-effective, one-stop shopping approach but still offer a level of personalization, are arguably one of the most elegant solutions.

Target-date funds have grown significantly in popularity over the last 8 years. According to the Investment Company Institute, target-date portfolios held $200 billion in assets in 2008, compared to just $9 billion in 2000.

Source: "The U.S. Retirement Market, 3rd Quarter 2008," *Investment Company Institute Research Fundamentals*; February 2009, Vol. 17, No. 3-Q3

Target-date portfolio variables

It is important to note, however, that not all target-date strategies are created equal. To date, there is no standard in the industry for addressing either the philosophy governing these funds or their construction. There are a number of variables in target-date portfolio construction and the range of how these are approached differ greatly among investment management firms.

"One reason why there is not a one-size-fits-all solution at retirement has to do with the divergent behaviors of people at retirement, Nagengast [principal at Target Date Analytics] suggested. At retirement, behaviors are all over the map, and so it is not as easy to come up with a model for distribution as it is for accumulation, he said."

- "What is a Target Date" by Ellie Behling; Planadviser, March 9, 2009

What does target date mean?

It may seem that the target date obviously refers to the date of retirement for participants. But does that mean that it requires a major shift in strategy for participants as they turn to income and principal protection instead of growth? Or is it a minor event, in which a small portion of assets is protected for income needs while the rest continues to be invested for accumulation and growth? Some retirees may intend to use only a small portion of their funds annually, content to maintain a majority allocated for growth. However, especially as we have seen in the recent market environment, the risk of equity investing so close to retirement can leave participants overexposed without enough time to recover any potential losses.

Target-date strategies: risk, glide path, and investment approach

There seems to be little agreement among fund managers about the amount of risk appropriate for a participant approaching or past the date of retirement, which is a reflection of different philosophies. For some managers, the target date represents a significant shift to a conservative allocation, focusing on preservation of capital. Others continue to maintain a large allocation to equities in preparation for many years of retirement during which savings can continue to grow.

The chart on the following page displays sample glide path allocations based on the target-date portfolios of several large fund families. The glide path refers to the gradual shift in the targeted ratio of equities to fixed income as the portfolio's time horizon changes; it reflects a measured reduction in risk over time as fewer equities and more fixed income instruments are included in the portfolio. While most target-date funds include a significant equity allocation during the portfolio's longer time horizons, the equity allocations as the target date approaches become more divergent, spanning from just over 20 percent to more than 60 percent of the portfolio.

One reason for maintaining a significant equity allocation past the target date is the ability to continue to capture growth in the markets after the participant has retired. Besides simply growing potential retirement income for participants, there is also the necessity for retirement income to keep up with cost of living increases. However, the market in 2008 offers us a vivid reminder of just how damaging volatility can be to the portfolios of retirees and pre-retirees. The tremendous amount of retiree wealth lost due to negative returns underscores one of the primary objectives of target-date portfolios: to minimize the risk that a participant will need to adjust their lifestyle and consumption in retirement to make up for investment losses.

A difficulty faced across target-date fund families is the inability for participants to select portfolios that take into account their own risk tolerance. To date, target-date funds are solely time-horizon-based, with the risk levels and corresponding asset allocation selected by the fund manager. Of course, a participant may select a portfolio with an alternate target date, but the need for this defeats the purpose of simplicity of target-date portfolios.

"T. Rowe Price's Director of Asset Allocation and Portfolio Manager Richard Whitney said T. Rowe (like some other fund managers) views target-date funds as a lifetime solution. He said 65 is not a 'magic' number; it is just the number when a participant stops accumulating.… However, not everyone agrees that individuals should continue to have a substantial investment in equities at retirement. Joe Nagengast, principal at Target Date Analytics, which offers a benchmarking tool for target-date funds, is one of those people. 'In our thinking, the target date is key — it should represent the end of the glidepath,' he said.… To put in perspective the difference over when the target date is, Nagengast said about two-thirds of the funds on the market ignore the date and one-third use the date by shifting to either wealth preservation or guaranteed income.… Kamila Kowalke, director of institutional markets at Dow Jones Indexes, which also provides target-date benchmarking, said she sees the target date as both the end of the accumulation phase and a bump in the road. 'It is an end point and at the same time it has to be designed so that people can stay for a couple years,' she said."

- "What is a Target Date" by Ellie Behling; *Planadviser*, March 9, 2009

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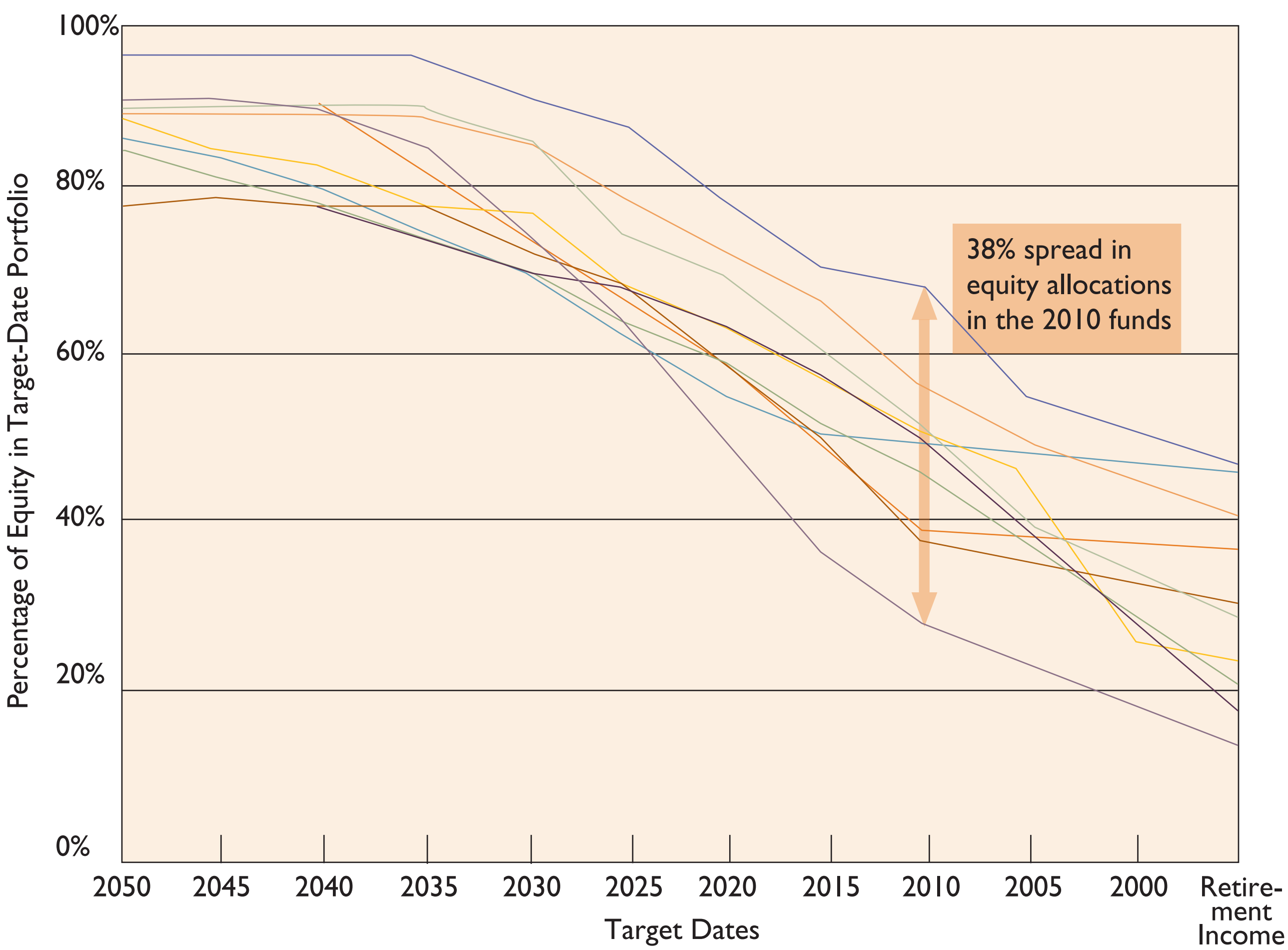
In addition to glide path disparities, there is inconsistency among target-date funds in terms of the asset classes and investment approach used. Some fund families maintain their portfolios using a largely passive approach, allocating with index funds across major asset classes only. Others take a more active approach. Not only may actively-managed funds be used in the allocation, but the asset classes included vary across fund families. Some target-date fund managers have begun including alternative assets in their portfolios as a way to reduce risk and enhance returns.

"Now, some of these funds are venturing well beyond plain-vanilla stocks and investment-grade gonds. They have added real-estate investment trusts, or REITs; stocks from emerging markets such as Brazil and Russia; inflation-protected securities; commodities and other alternative assets once found mainly in traditional pension plans."

- "Target-Date Funds Shake Up the Mix" by Jeff D. Opdyke; The Wall Street Journal, August 30, 2007

Sample Equity Allocations (Glide Paths) in Target-Date Funds as of 2/28/09



This chart represents sample equity allocations based on the glide path allocations from several major target-date fund families as of February 28, 2009. This chart is representative and meant for illustrative purposes only.

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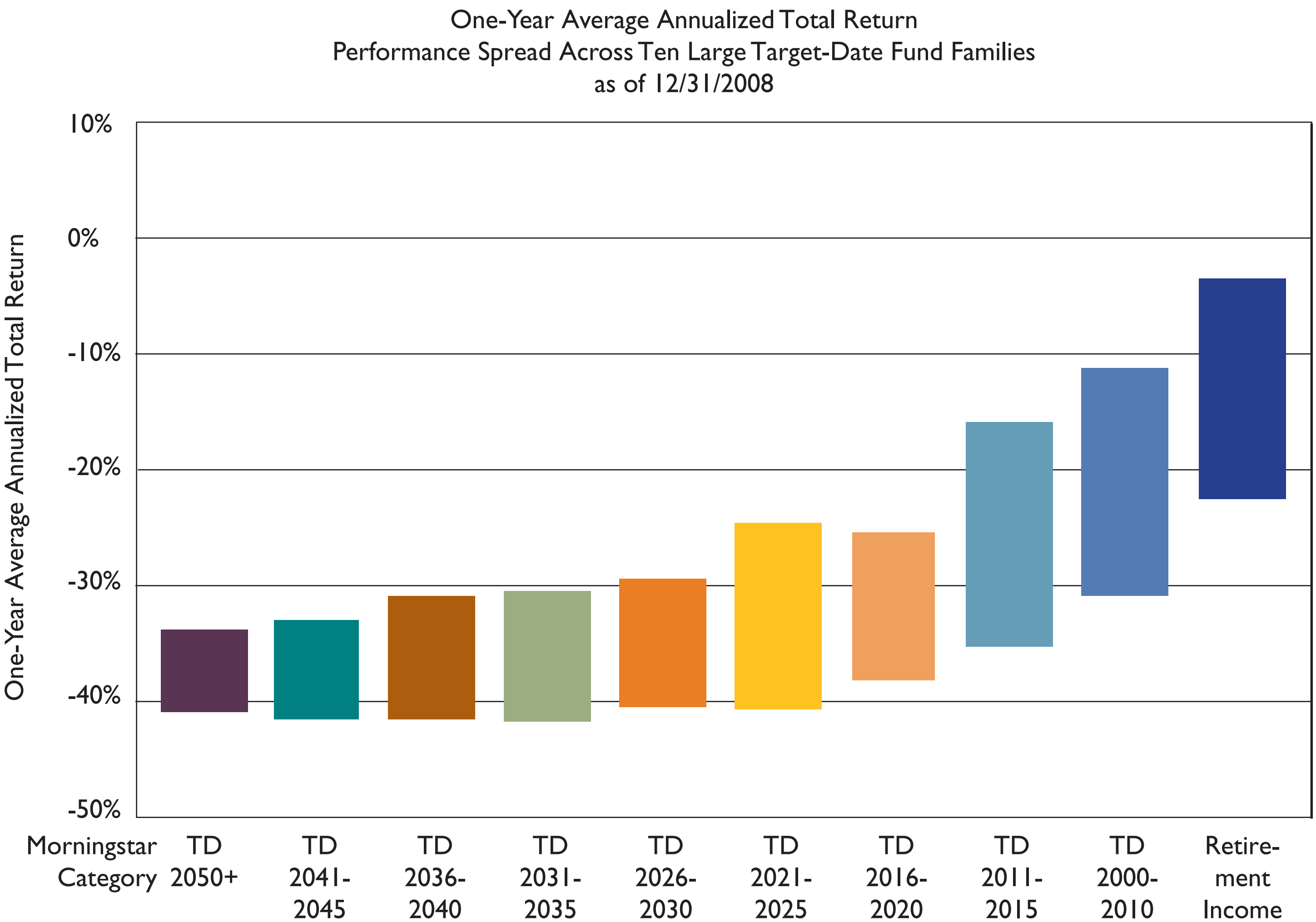

This chart represents performance returns from several major target-date fund families as of December 31, 2008. This chart is representative and meant for illustrative purposes only.

Performance

As one might expect, the performance of target-date funds is as varied as the glide path allocations. The performance spread is particularly pronounced among those funds with an approaching target date; in the Morningstar category of target-date funds targeting 2011-2015, the one-year annualized total return (as of December 31, 2008) varied between approximately -16% and -35%. These funds garnered Morningstar rankings between 4 and 77 for this time period.

Evaluating target-date funds

Benchmarking target-date funds can be difficult given the variables. There seem to be as many approaches to benchmarking target-date funds as there are approaches to allocation. Some indexes have been created specifically to provide benchmarks for target-date funds. For example, Dow Jones Indexes, Target Date Analytics, and Morningstar have all established indexes to measure target-date fund performance. However, their methods vary. Whether an index uses its own asset mix or peer groups as a basis, it is unlikely to align with the unique allocation and glide path structure of a given target-date fund or fund family, resulting in a misleading performance spread. Another potential solution is to create a custom index with a mix of asset class indexes corresponding to the target-date fund's target allocation.

"Index and peer-group comparisons can generally be considered measures of short-term opportunity cost.... In addition, the existing benchmarks do not help investors answer the most important questions about target date funds:

- What return does an investor need to earn to accumulate enough money for retirement?
- Does the investment provider expect its mix of embedded asset allocation advice and fund selections to meet this return threshold?
- Is the fund meeting these expectations?
- What risks are implied by these expectations?"

- "Target-Date Funds and Goal-Based Benchmarks," Vanguard Investment Counseling and Research, 2007

In the cases of benchmarking versus peer groups or an established index, the index is measuring the opportunity cost — the cost of being invested in that particular target-date fund as opposed to selecting one with a different asset mix. In the case of creating a custom index, there is no measure of whether the value added by the target-date fund's asset allocation will actually help a participant earn enough money for retirement. There is no simple solution to this dilemma, but an awareness of the issue can help plan sponsor committee members make informed decisions.

Target-date portfolios moving forward

As target-date funds become more ubiquitous among DC plans, even the Senate Special Committee on Aging has taken note of the wide variance of their structures and philosophies. Whether or not target-date portfolios will be faced with greater governmental oversight, it is important for plan sponsors to understand that target-date strategies are not all created equal.

> "'Despite their growing popularity, there are absolutely no regulations regarding the composition of target-date funds,' said [U.S. Senate Committee on Aging Chairman and Senator (D-Wisconsin) Herb] Kohl. 'With more and more Americans relying on 401(k)s and other defined contribution plans as their primary source for retirement savings, we need to make sure their savings are well-protected with strong oversight and regulation.'"
>
> - "Senate Committee Takes Aim at Target-Date Funds" by Nevin. E. Adams; *Planadviser*, February 2, 2009

However, with this understanding and with careful thought and analysis, plan sponsors may be able to provide great value to their participants in choosing to implement target-date portfolios. Following are a few considerations that may assist committee members both in deciding whether or not these options will serve their plan and also in selecting a method of implementation that will be most appropriate for their participant population.

- Are we prepared to invest in the additional research required to select appropriate target-date funds?
- How will we define the risk profile of the target-date strategies that will be the most appropriate fit for our plan?
- What is our plan for benchmarking and measuring the success of our target-date portfolios?
- How does the risk profile and target-date strategy align with other default features in our plan?
- What is our strategy for participant communication regarding target-date portfolios? How will we ensure that our employees have an appropriate understanding of the risks and the value of our target-date funds?

This paper is intended to assist our plan sponsor clients in better understanding target-date portfolios and the questions and issues involved in choosing to offer a target-date solution to defined contribution plan participants. These options have the potential to provide great value to participants in an environment in which inertia, misinformation, and passive decision-making are a significant obstacle to retirement security. It is our hope that the information provided here serves to initiate a dialogue with your consultant about how to take advantage of the opportunity and make choices that will best serve your participant population.

Endnotes:

"The Behavioral Economics of Retirement Savings Behavior" by Richard H. Thaler and Shlomo Benartzi; AARP Public Policy Institute, January 2007

"Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance" by James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick; Tax Policy and the Economy, November 9, 2001

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