Target-Date Funds
Are they hitting the target?

Arnerich Massena, Inc.

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Target-Date Funds: Are they hitting the target?

March 1994 marked the advent of target-date funds. Despite valiant efforts to educate employees about asset allocation strategies and prudent long-term investing, participants were still struggling, reflected by their largely inadequate account balances. The first target-date funds were introduced by Wells Fargo and Barclays Global Investors, followed within a few years by Fidelity. Over the next five years, other firms saw the genius of the idea and Principal, T. Rowe Price, and Vanguard (among others) issued their own target-date funds in the early 2000s.

Now a decade has passed, and target-date funds have become commonplace across the defined contribution industry. Whether you have already incorporated target-date funds or are considering their addition to your plan, this is an excellent opportunity to review their progress, the changes they have undergone, and ultimately ask the question, “are they hitting the target?” Are target-date funds accomplishing their goal of providing long-term investment allocations that will provide growth, preservation of capital, and, finally, a secure retirement nest egg for participants?

“More than three-quarters of 401(k) plans included target-date funds in their investment lineup at year-end 2009. At year-end 2009, nearly 10 percent of the assets in the EBRI/ICI 401(k) database was invested in target-date funds and 33 percent of 401(k) participants held target-date funds.”

- Holden, VanDerhei, Alonso, 2010

“As anyone who has ever conducted an employee investment education meeting knows, at the end of all the sincere charts and presentations, investors would approach the meeting leader and say, ‘I understand all that allocation and risk-return stuff, but would you just tell me what to do?’”

- Target Date Analytics, January 2011

Drawing the target

The initial purpose of target-date funds was to accomplish what participants were not doing for themselves, creating a diversified investment strategy that shifts its allocation as one’s retirement time horizon nears. How that purpose is accomplished has been shifting nearly as much as the allocations themselves since the inception of the target date concept.

When target-date funds began gaining traction in the marketplace (in the mid-2000s), the stock market was highly bullish. Regulatory agencies were about to establish qualified default investment alternatives (to be utilized when participants do not make an active investment decision), and target-date funds were making headlines as a likely candidate for QDIAs. A race for assets began, escalating with efforts to improve performance. Firms began to allocate their target-date funds more aggressively in an attempt to show competitively higher returns and thereby garner more attention and assets.
When the Pension Protection Act was passed in 2006 and target-date funds became established as QDIAs, inflows increased dramatically. While all three QDIA options (managed accounts, target-risk or balanced funds, and target-date funds) grew at this time, target-date funds grew the fastest: “from a net asset base that was smaller than target-risk funds in 2006 to a position where open-end target-date fund assets are more than double those of target-risk funds and nearly five times that of managed accounts. Looking at data from the Investment Company Institute, Ibbotson noted that target-date funds account for approximately 57 percent of all QDIA options.” (Charlson & Lutton, 2011)

By this time, however, there was a huge disparity in how seemingly-similar target-date fund vintages were constructed. Equity allocations in funds approaching their target date varied from as little as 25 percent of the fund to as much as nearly 75 percent of the fund. When the credit crisis hit, a number of target-date fund investors nearing retirement found themselves having lost a significant portion of their capital due to the aggressive allocation of their supposedly “conservative” investment. The issue of glide path construction became front and center.

Debate around target-date glide path construction rose to the level of Congress and the Department of Labor, inspiring proposed regulations about the communication of target-date funds to participants. The result was a proposal that plan sponsors provide participants with a description of their target-date funds’ objectives and glide path, including graphic illustration of how the funds’ asset allocation was intended to shift over time. Disclaimers addressing some common misperceptions were also included in the proposal.

**Target-date funds today**

Target-date funds are still adjusting to market and industry demands. There continues to be little homogeneity in how target-date funds are constructed and how the glide path is determined. Although active strategies remain dominant, some target-date funds include passively-managed assets, a segment that appears to be growing. The level of non-U.S. investments in target-date funds varies widely, and the nature of the fixed income investments in target-date funds can range from investment-grade only to significant exposure to high yield. Recently, many target-date fund managers are considering or have already added alternative investments, such as commodities, real estate, and real return assets.

“Some of the largest providers have been incrementally expanding their strategic allocations and underlying funds into less-traditional areas, while some newer entrants to the target-date scene have taken fairly bold steps into alternatives.”

- Charlson & Lutton, 2011

Figure 1 shows the asset class exposure for ten large target-date fund families. While all ten have U.S. large, mid, and small cap equity and U.S. fixed income, for example, only half incorporate international fixed income or emerging markets debt. Most now include REITs, and commodities are still only included in 40 percent of this sample.
The glide path continues to be a source of debate, with glide path structures and asset allocations among target-date fund families continuing to evolve and change. The focus currently is on whether construction of the allocation is geared to take participants “to” retirement or “through” retirement. The assumption is that a “to” target-date fund is intended for liquidation or rollover at retirement and thus reaches its most conservative allocation prior to or at that time. A “through” portfolio, on the other hand, may still be invested for growth at retirement age and continue its glide path slope into retirement. Theoretically, this distinction seems to be sensible, but in practice, there is so much variability, even among funds that describe themselves as one or the other, that they can be difficult to categorize. Until standards are established for the practical difference between a “to” fund and a “through” fund, the designation does not necessarily assist sponsors or participants in understanding a fund family’s underlying glide path structure.
In Figure 2, you can see that retirement portfolios still range between 25% and 65% exposure to equity. Diversification varies widely as well; they may hold as few as seven asset classes or as many as 12. Because target-date funds are not built to established standards, plan sponsors bear some burden for understanding the structure and philosophy behind the target-date funds in their plans. With the growing array of asset classes, plan sponsors with target-date funds need to be aware of their fiduciary exposure.

**Are they hitting the target?**

In spite of their rapid growth in the marketplace, target-date funds are still relatively new, which makes it difficult to effectively evaluate their long-term impact on participant outcomes. Also, target-date funds currently tend to be used more by younger workers. The Employee Benefits Research Institute and Investment Company Institute found that at the end of 2009, target-date funds were most

“At year-end 2009, 44 percent of participants in their twenties held target-date funds, compared with 24 percent of participants in their sixties in 2009.”

- Holden, VanDerhei, Alonso, 2010
Target-date funds

popular with those in their 20s and 30s, declining in popularity with workers’ ages. They also tend to be used more by workers with shorter tenure than by long-tenured workers, largely as a result of being a default option for automatic enrollees. (Holden, VanDerhei, Alonso, 2010)

Vanguard’s 2010 survey concerning target-date funds revealed that many retirement plan participants who own target-date funds are not aware of what they are. However, of those who are aware, they tended to have a sound understanding of how target-date funds work. The survey further revealed that a majority of investors plan to remain invested in equity to some degree after retirement and are comfortable with post-retirement stock exposure. (Ameriks, Hamilton, Ren, 2011) This suggests both that target-date funds are serving the purpose of providing diversification for those participants who are unaware of their investments, and that those participants who are aware are comfortable with a “through” approach to allocation.

While the market crash of 2008 put a dent in target-date fund performance, on the whole, they have performed in line with what one would expect of a fund with a broad mix of equity and fixed income. In 2008, target-date funds with shorter time horizons outperformed the broad stock market and the retirement income funds outperformed the balanced index, demonstrating the benefits of age-appropriate asset allocation to help preserve capital. In the past two years, target-date funds with longer time horizons outperformed the balanced index, some by quite a margin in 2009. Because the target-date fund industry is still young, it may be premature to draw any conclusions about their long-term performance; however, recent results are promising.

Table 1 Target-Date Fund Annual Fund Performance (Morningstar universe of U.S. target-date funds)

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<tr>
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<tbody>
<tr>
<td>Retirement Income</td>
<td>8.9%</td>
<td>18.4%</td>
<td>-18.1%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2000-2010</td>
<td>10.7%</td>
<td>22.4%</td>
<td>-22.5%</td>
<td>5.2%</td>
</tr>
<tr>
<td>2011-2015</td>
<td>11.5%</td>
<td>23.5%</td>
<td>-27.8%</td>
<td>5.8%</td>
</tr>
<tr>
<td>2016-2020</td>
<td>13.3%</td>
<td>28.3%</td>
<td>-29.5%</td>
<td>6.5%</td>
</tr>
<tr>
<td>2021-2025</td>
<td>13.3%</td>
<td>28.3%</td>
<td>-34.2%</td>
<td>6.5%</td>
</tr>
<tr>
<td>2026-2030</td>
<td>13.5%</td>
<td>28.9%</td>
<td>-36.0%</td>
<td>6.5%</td>
</tr>
<tr>
<td>2031-2035</td>
<td>14.3%</td>
<td>30.1%</td>
<td>-37.0%</td>
<td>7.0%</td>
</tr>
<tr>
<td>2036-2040</td>
<td>14.4%</td>
<td>30.9%</td>
<td>-37.9%</td>
<td>6.2%</td>
</tr>
<tr>
<td>2041-2045</td>
<td>14.6%</td>
<td>30.9%</td>
<td>-38.1%</td>
<td>5.9%</td>
</tr>
<tr>
<td>2050+</td>
<td>14.6%</td>
<td>32.2%</td>
<td>-38.9%</td>
<td>5.9%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>15.1%</td>
<td>26.5%</td>
<td>-37.0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>BC U.S. Agg Bond Index</td>
<td>6.5%</td>
<td>5.9%</td>
<td>5.2%</td>
<td>7.0%</td>
</tr>
<tr>
<td>U.S. Balanced Index*</td>
<td>12.2%</td>
<td>18.5%</td>
<td>-21.6%</td>
<td>6.2%</td>
</tr>
</tbody>
</table>

Source: Morningstar, Inc.

*60/40 S&P 500 Index / BC U.S. Aggregate Bond Index

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Aiming for success: custom or off-the-shelf

For those plan sponsors who adopt target-date funds, one of the biggest decisions is whether to select an off-the-shelf fund family or to create custom target-date funds using the plan’s investment options as the underlying funds. There are advantages in either case, and plan sponsors should carefully consider their options before making a decision.

Custom target-date funds

One of the greatest benefits of creating custom funds is the ability to use the underlying funds in the plan. It is rare for a fund family to sustain best-in-class funds across all asset classes, particularly as new asset classes are incorporated into target-date funds; custom funds allow the Committee greater freedom to select those funds they deem most appropriate to the plan. This freedom may also make it easier for plan sponsors to control the costs of the funds, using index funds where appropriate. And the Committee is able to adjust allocations to specifically meet the needs of plan participants. However, there are some issues plan sponsors face that they should be aware of before taking this route:

- **Fiduciary responsibility:** Who is fiduciarily responsible for creating and maintaining the glide paths of the funds? This is no small task, and committees should be prepared to either take responsibility or hire an advisor who can do so (although committees will never be able to fully relinquish their fiduciary responsibility, even when working with an advisor).

- **Administration:** There are likely to be additional costs, such as unitization or valuation, to administering custom-created target-date funds.

- **Communication:** Who is going to create the materials necessary to communicate to participants about the target-date funds? Not only will you want to be in compliance with the DOL regulations, but you’ll want to help participants understand their options and how best to use them.

Plan sponsors who are exploring custom target-date funds need to ensure that they can plan for the increased fiduciary responsibility and potential additional costs.

Off-the-shelf target-date funds

Off-the-shelf target-date funds don’t offer the same range of options as custom funds, but they do provide ease of use. Fewer decisions need to be made. Plan sponsors can leverage the marketing collateral of the fund company rather than having to create custom educational materials. Keep in mind, though, that not all target-date funds are created equal. Because there is so much variability, plan sponsors will want to look closely at all of their options before selecting off-the-shelf target-date funds. With off-the-shelf target-date funds, plan sponsors should pay attention to:
Target-date funds

Glide path: Are the glide path allocations appropriate for the way you intend your participants to use them? Are the equity allocations conservative/aggressive enough to fit your participants’ needs?

Fees: Are the fees reasonable?

Communication: Are communications straightforward and easy to understand? Are they adequate for your participants, and do they meet all regulatory requirements? Is there clarity regarding the purpose and construction of the funds?

Plan sponsors who have off-the-shelf target-date funds or are considering off-the-shelf target-date funds should make sure that they take the time to understand the fund family they select, and where it fits in terms of glide path, equity exposure, asset class diversification, and cost.

Are your target-date funds on target?

Target-date funds have yet to fully prove themselves as an ultimate solution to the problem of helping participants save and invest wisely. There remain issues to be considered, thought through, and resolved. However, the concept is sound, and the early years have been promising, even despite some bumps along the road. Without doubt, these funds will continue to evolve and improve.

We encourage plan sponsors to look into target-date funds and assess their own plans to decide whether their addition, or modifications to their present implementation, would add value to participants. We also caution employers to make sure they understand the full implications prior to creating custom target-date funds. This can be a highly beneficial solution, but may require a greater degree of cost and fiduciary responsibility than plan sponsors may initially be aware of.

We recommend that plan sponsors discuss the following with their advisors:

1. Should I consider adding target-date funds to my current plan line-up?
2. How have my target-date funds evolved over time? Has the philosophy shifted? Has the glide path structure changed?
3. Should I consider exploring a custom target-date fund solution?
Endnotes:


Charlson, Josh, Ph.D. & Lutton, Laura Pavlenko; “Target-Date Series Research Paper: 2011 Industry Survey” Morningstar Fund Research, April 2011

Department of Labor Employee Benefits Administration; “Target Date Retirement Fund Disclosures Fact Sheet” November 29, 2010


Profit Sharing/401(k) Council of America (PSCA); “53rd Annual Survey Reflecting 2009 Plan Experience” 2010

Target Date Analytics LLC; “A Brief History of Target Date Funds,” January 2011