P-Solve Update

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Target Date Funds: Three Things to Consider

Target Date Funds (TDF) have become increasingly important to the retirement security of 401(k) investors. As with any investment option, plan fiduciaries have a duty to select and monitor their TDF according to a prudent and informed process. This duty is complicated by TDFs' multi-layered structure.

This article addresses three major features common to most TDFs' structure: asset allocation (specifically, equity exposure), management style (including active and passive management, use of proprietary funds, and tactical asset allocation), and fees – which, if not evaluated carefully and on a manager-by-manager basis, could result in a mismatch between an employer's goals and participant investment results.

Asset Allocation (Equity Exposure): The largest TDF managers take very high levels of stock market risk in longer-term funds, ensuring that participants will bear the full brunt of any market downturn. Even shorter-term funds have relatively high levels of stock exposure - higher than what is typically found in defined benefit (DB) pension funds. While appropriate for some participants, heavy reliance on equities is almost certainly not suitable for as many 401(k) participants as the allocation of the largest TDF managers suggests. TDFs are built mainly for favorable economic and market environments.

Management Style: Most TDF assets are invested primarily in proprietary, actively-managed funds. This contrasts with professionally-managed pension funds that normally invest in a mix of passive funds and active funds, and through a variety of investment management firms. Further, most TDFs use Tactical Asset Allocation (TAA), tilting away from long-term, strategic weights in an attempt to outperform their benchmark. This is a form of market timing for which most investors are unlikely to be rewarded.

Fees: Investment expenses of the typical TDF are higher than mutual funds and professionally-run DB plans.

The overwhelming market share enjoyed by the largest TDF managers suggests that either all plan sponsors agree on appropriate levels of market risk, active management, and use of proprietary versus outside underlying funds or, more likely, that many sponsors have not sufficiently considered the unique needs of their participants.

We believe that evaluating a variety of TDF managers with different portfolio construction and management approaches is an imperative for plan sponsors.

Background

TDFs provide investors with a professionally-managed "fund of funds" portfolio of various asset classes blended to exhibit risk and return behavior appropriate for an investor expecting to retire in a particular year. For example, a participant who is today 12 years from assumed retirement at age 65 would select (or be assigned to) a "2030" fund. TDFs typically rebalance to long-term, strategic asset class targets periodically, and feature an investment mix that changes according to a projected future asset allocation or "glide path," becoming more conservative (shifting from stocks to bonds) over time. Thus a TDF, once chosen, in theory requires no further action by the participant. They are "automatic."

Some TDFs invest "to" retirement, assuming immediate withdrawals at that point, others "through" the date of retirement. The "to versus through" designation is not always informative however, as the designation may not say much about equity exposure and risk.

Longer-dated TDFs, intended for younger investors, are generally invested mostly (almost entirely, in many cases) in stocks on the assumption, supported by U.S. market history, that stocks will go up on average over time, and that younger investors should balance their "human capital" (the present value of potential future earnings) with investment capital.

TDFs have seen enormous growth since receiving "Safe Harbor," qualified default ("QDIA") status by the Pension Protect Act of 2006.[1] TDF assets barely totaled $150 billion in 2007; they now total nearly $1 trillion.[2]

TDFs can consist of active underlying managers, passive managers, or both. About a decade ago, active managers dominated the marketplace (with 83% of assets in 2006, according to Morningstar[3]); passive managers have closed the gap somewhat in the last decade or so, reducing the all-active TDFs' share to just about 60%.[4]

Together, Vanguard (all passive), Fidelity (a mix of passive and active), and T. Rowe Price (historically all active but recently having added some passive exposure), dominate the TDF market with over 70% of assets. American Funds, JP Morgan, and TIAA account for another 15% of TDF assets. In this article, we will refer to these firms collectively as the "Big Six" for convenience, though Vanguard, with about $280 billion in assets, has nearly 10 times JP Morgan's total assets.[5]

TDFs are a great improvement over static, one-size-fits-all "balanced portfolios", and provide investors seeking diversification, professional management, and gradual risk reduction with a convenient alternative to going it alone. However, the market share of the Big Six, and their ultimately very similar asset allocations, suggests that plan sponsors with unique goals or plan participant characteristics may need to more carefully consider alternatives to the current marketplace consensus.

Equity Exposure

The typical defined benefit pension fund, intended to operate in perpetuity, allocates approximately 60-70% of its assets[6] to equities and equity-like (riskier, growth-oriented) asset classes, and the remainder to more conservative asset classes, including government and corporate bonds. Longer-dated TDFs, however, routinely allocate 80% or more to equities, as shown in the table below.

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[1] Providing plan sponsors prudently select and monitor their TDF manager, a performance "safe-harbor" is available.
[2] *Target Date Fund Landscape,* Morningstar, 2017.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] P-Solve surveys of non-frozen pension plans, and author experience. Confirmed by studies such as: Deloitte, *Asset Allocation of Defined Benefit Pension Plans,* November 2015.

Equity Exposure (%) by TDF Family[7] and Fund as of 12/31/2017

Fund Family / Strategy	Income[8]	2010	2020	2030	2040	2050	2060
Vanguard	29	29	53	69	84	88	88
Fidelity Freedom	23	41	56	74	87	87	88
T. Rowe Price	None	41	58	73	84	86	86
TIAA Lifecycle	37	40	51	68	84	90	91
JP Morgan Smart Ret.	35	NA	48	66	80	82	90
American Funds	None	41	48	69	82	84	84

The premise behind high-equity allocations for younger investors is reasonable: stocks tend to go up over time as the economy and company earnings grow, and investors with longer-horizons can, in theory, tolerate even sizable market declines providing recovery follows. Investors should also diversify their relatively high stock of "human capital" with other investments, like stocks. In some cases though, TDF stock exposure may be too high.

Consider that pension funds, unlike individual 401(k) plan accounts, are intended to operate indefinitely, and can in theory take more risk than any individual. The table above shows equity exposure by TDF for each of the Big Six. Taking 70% equities as reasonable for a long-term investment pool like a pension fund, we find that stock levels are well above this target for all TDF families beyond 2030 funds.

Consider also that the typical pension fund participant is approximately 50 years old and eligible to retire in about 15 years, and that the assets invested on their behalf are allocated roughly 65% to riskier investments. The same investor, if assigned to a 2030 or 2035 TDF, would be exposed to 70% to 75% equities– a meaningful "overweight" to stocks relative to DB plans. In 2008, when the broad US stock market declined by about 37%, this overweight harmed retirement prospects: while the typical pension fund lost between 20 and 30%, the average 2030 and 2035 Big Six TDF losses were 35% and 36%, respectively).[9] TDF losses in 2008 were, on average, equal to or greater than those experienced by the S&P 500, despite their diversification.

If an investor or sponsor believes that stocks will continue to both go up over time and outperform bonds, extreme equity levels may be rewarded. But such an investor should be prepared for extreme volatility as well.

As currently structured, most TDFs will continue to behave mostly like equities in both good and bad markets.

Tactical Asset Allocation

With the exception of Vanguard, each of the Big Six TDF managers employs a form of active management known as Tactical Asset Allocation (TAA). That is, they "tilt" away from long-term asset class weights in an attempt to outperform a strategic-asset-allocation mix or benchmark. TAA is of course just market timing, and is very hard to execute successfully – much harder than traditional active bond or stock management, as it involves a small number of very concentrated active "bets" that must be timed nearly perfectly. The ability of TAA to generate excess returns consistently is doubtful.[10]

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7 As reported by Morningstar. Exposures rounded to the nearest whole number.
8 An "Income" Fund, where applicable, is intended for retirees. "None" indicates no offering.
9 For institutional or R6 share classes, as reported by Morningstar.
10 AQR, *Tactical Tilts and Foregone Diversification*, April 2014.

Active Management

Few professionally-managed DB pension funds employ active management exclusively.[11] Recognizing that some asset classes are more fertile ground for a skilled active manager than others, DB plan sponsors tend to use a blend of active and passive management. The largest TDF managers by assets, other than Vanguard (naturally), have reached the opposite conclusion however: they use mostly active management.

The theoretical case for active management *in all or nearly all asset classes* is weak, and the case for active management *by one firm*, exclusively, is also weak.

When evaluating the prospects of active management, it is useful to keep in mind that, on average, active managers must underperform due to expenses.[12]

Considering the difficulty of active management, the rarity of true active manager skill, and the case for passive management in more liquid, analyzed and thus "efficient" asset classes, a combination of passive and active management may be preferable.

Use of Proprietary Funds

The Big Six TDF managers' largest TDF offerings consist entirely of affiliated funds; they use no outside managers.

In the case of an index TDF, this is not troublesome, providing the index manager is proven, as is Vanguard.

In the case of a partially or completely-actively-managed TDF however, the use of one management firm across a dozen or more actively-managed strategies is problematic: a professionally-managed pension fund, recognizing the rarity of active manager skill and the importance of manager diversification, would likely not make a concentrated "bet" on a single organization.

For the same strong theoretical reasons that an investor should favor both active and passive underlying TDF managers, plan sponsors might consider a TDF family that uses multiple managers.

Fees

TDF fees continue to fall. At the end of 2016, the average asset-weighted expense ratio was 0.71%, according to Morningstar,[13] while as recently as 2011, the average was 1%.This improvement is due in part to the increased use of passive funds, but also to fee reductions. The trend is positive, but on average TDFs remain as, or more, expensive than actively-managed mutual funds. The average 401(k) equity mutual fund management fee is about 0.48%, and the average bond fund fee 0.35%.[14] The average TDF fee of about 0.70% thus seems high relative to any blend of stock and bond funds, even accounting for strategic asset allocation advice, rebalancing and other "features" like TAA, which as we have discussed may or may not add value over time.

TDF fees should continue to decline as assets grow.

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[11] P-Solve surveys.

[12] William Sharpe, *The Arithmetic of Active Management,* Financial Analysts Journal, Jan/Feb 1991.

[13] Morningstar, *2017 Target Date Fund Landscape*, 2017.

[14] Investment Company Institute, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2016.

Summary

TDFs have many virtues, but the *typical* TDF may not be suitable for some plans.

The typical TDF takes high levels of equity risk, attempts market timing that is unlikely to be rewarded on average, uses much more active management than most pension funds, and is expensive.

High equity exposure forced many to delay retirement, or accept a reduced standard of living in retirement, during the market crash that accompanied the Global Financial Crisis of the last decade. Though a repeat of this episode seems unlikely, even a less-severe downturn could result in permanent losses for those on the cusp of retirement.

Retirement plan sponsors should give strong consideration to TDF managers that avoid extreme reliance on equities, that refrain from excessive tactical tilts unlikely to be rewarded on average, and that charge fees that are reasonable considering expected performance.

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