

Twelve observations on target date funds

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A participant in a target date fund is entrusting the plan sponsor to determine what is the best investment solution on their behalf. This is a serious responsibility...

There seems to be growing consensus in the retirement industry that target date funds are going to be a critical component of most defined contribution plans. Plan sponsors, participants, money managers, consultants and even the U.S. government have acknowledged the power of target date funds to provide an effective solution to the asset allocation decisions participants have historically had to make on their own.

Plan sponsors have a great deal of choice available, but target date funds require a different type of analysis than they are used to. As someone who has worked with plan sponsors to help select and implement target date fund solutions, I've come to appreciate the differences between approaches – and there truly are differences between approaches. I share below 12 observations based on my experience to date:

Observation #1: Target date funds should be designed with specific objectives in mind.

Target date funds should be seen as a component of an overall retirement program. You'll note I didn't say savings program. Greater certainty in retirement income replacement should be the goal of a target date fund – and asset accumulation is only one part of that. A target date fund series is not merely a set of portfolios designed for different points in someone's life. Rather, it should be seen holistically as a continuous retirement program designed to meet specific objectives.

Observation #2: Glide paths (equity to fixed income allocation) slope down because of contributions, not because of time horizon.

You may hear statements like: "you can be more aggressive when you have a longer time horizon because you have more time to make up for losses." This line of thinking is flawed¹. The real reason a glide path should slope down is because early in someone's career, their retirement income expectation is based on a small amount of accumulated savings and a whole lot of human capital, in the form of future contributions. So a young saver can invest more of their savings in risky asset classes (like equities) because their human capital acts more like a bond. As accumulated savings grow and expected future contributions get smaller, the savings are increasingly invested in less risky asset classes.

Why is this esoteric distinction important? As I will discuss in other observations, I have found that a glide path manager's understanding of this difference drives the design of different target date funds in important ways. A target date fund should be built from sound principles.

¹ For a brief description of why this is so, see Smith, Matt and Bob Collie. "Sequential Risk: When it comes to investment returns in defined contribution (DC) plans, 'when' can be almost as important as 'how much.'" Russell Investments. February 2008. For a fuller analysis, see Gardner, Grant and Yuan-An Fan, "Russell's Approach to Target Date Funds - Building a Simple and Powerful Solution to Retirement Saving." Russell Investments. January 2008.

Observation #3: Risk should be measured in terms of not meeting retirement objectives.

Conventionally, investment risk is measured by some volatility calculation, like standard deviation of returns. But that point-in-time measurement of asset return volatility is meaningless in a 40-year savings program. The more important risk is falling short of your goals of meeting certain levels of income replacement at retirement.

Also, it's important not to think of this risk measurement as an "all-or-nothing" proposition. I have found that some target date funds that define risk simply as running out of money in retirement (without recognizing that there is a big difference between not meeting a goal by \$1 and not meeting it by \$1 million) tend to be much more aggressive. That's because they've defined their goal as either you met it or you didn't.

Observation #4: It's okay to have high equity allocations at the beginning of the glide path. In fact, you should.

Remember my human capital discussion in observation #2. For example, a young saver just starting to put money away will have a relatively small account compared to what it is projected to be in the future. Much of the growth of a young saver's account early on is going to be driven by plan contributions. So, one can typically afford to have a high equity allocation without worrying that a large negative return will have a meaningful impact on final expected wealth.

As explained in our recent note on sequential risk², the timing of investment returns is critical in a DC plan. Sequential (or timing) risk is lowest in the early years of saving. That means that, in the context of the overall program, this may be the best time to take maximum risk on accumulated savings.

Observation #5: It's not okay to have high equity allocations at the retirement end of the glide path.

This is the corollary to the sequential risk discussion above. By retirement, there are no more future contributions to offset the risk in the investment portfolio. A negative return near to retirement has significant impact on the amount of income that the plan will provide.

Those glide path managers who have more aggressive allocations at the retirement date will look like winners if the risk is rewarded and returns are good – but this approach is at odds with the holistic retirement program that a target date fund should represent. I'm not sure "swinging for the fences" is the right solution here. Think of the person who retired in March 2000 and experienced sharply declining markets for three years after that: it's hard to recover from such losses when money is already coming out of the account. There is significant timing risk when taking too high an equity allocation at retirement.

Observation #6: There is no clear investment rationale for the glide path to continue to slope down after retirement.

You are at your maximum risk exposure at retirement because you have the longest time to fund retirement income. Your asset allocation in retirement should be more a function of how you react to experience than to time. However, since we can't know everyone's experience, a flat glide path is a reasonable place to start.

Some glide paths are more aggressive at the target retirement date and continue to slope down for many years into retirement. However, this becomes the sequential risk

² Smith Matt and Bob Collie. February 2008. Op. cit.

argument in reverse. Now you are most vulnerable to a negative return at the beginning of your disbursement of assets.

Observation #7: Target date solutions should provide diversified sources of return.

Doesn't every investor seek to push out the efficient frontier by diversifying into uncorrelated asset classes? Yet, many say we shouldn't expose "naïve" defined contribution investors to more volatile asset classes like REITs or emerging markets. I could agree with that if you are talking about offering these as standalone options. However, as a part of a broader portfolio where it is the volatility of all of the assets together that counts (not that of each asset in isolation), it may make sense to provide these types of exposures wherever possible. In fact, a good fiduciary who wants to meet prudent investor standards should consider this.

Observation #8: Passive should not be considered the safe choice.

An example of a prudent investor is someone who makes decisions that they believe are in the best interests of the participants. They are not necessarily taking into account fee minimization, convenience or the tracking of market index performance. There is a notion floating around that because these are default options, a fiduciary is in a safer position by offering low cost, low tracking error options. However, to me this seems like a solution more driven by the fiduciary's own interests than the participants'.

I'm not arguing that passive investing is bad and isn't the right solution for some³. But, I'm concerned how some are coming to that conclusion. Indeed, we find that most large investment programs, whether defined benefit, endowment or the individual options in a defined contribution plan, use a combination of active and passive management. If an active/passive mix is a prudent decision for those plans, it may be prudent for a target date fund as well. How can a plan sponsor explain to participants that it's important for their DB plan to pay for the best investments, but the DC plan just gets whatever investments are cheapest? And if a plan sponsor doesn't consider low risk, all passive investing the most prudent choice for an organization's DB plan, why is it considered appropriate for its DC plan?

Observation #9: Proprietary managers face headwinds.

Many target date solutions are offered by investment companies that use their own proprietary strategies within the funds. Such providers are challenged to argue that they can provide best-of-breed approaches across all asset classes. In addition, there are issues surrounding the independence and objectivity of those making the decision of which underlying strategies to use. Further, plan sponsors should evaluate the commonality of holdings and themes across underlying strategies from a certain provider, as well as the ability to gain access to capacity-constrained strategies in the target date fund.

Observation #10: Building your own target date fund is harder than it sounds.

Some larger plan sponsors like the idea of creating a customized target date fund built from, for example, the asset class funds that are already being offered in the plan. This can make sense, but while it can appear straightforward on the surface, I think it's a challenge to implement effectively and for the long term.

Plans thinking of going down this route should make sure they have the dedicated staff resources, an appropriate amount of assets to make it cost efficient, and the right

³ More detail of Russell's position on this question can be found in Collie, Bob. "The Risks and Benefits of Active Management in Target Date Funds. It Doesn't Have to Be Either/Or." Russell Investments. July 2007.

partner to do this. Weak implementation can wipe out any potential benefits. And, while you may feel comfortable that you can set this up today, investment programs are never static: the structure has to be maintained over the long term, when those who created the options may have moved on to do something else.

Observation #11: Take care with performance comparisons.

Everyone wants to compare performance of funds versus other funds to make a value judgment of which is better. I can tell you that a simple comparison of returns of different providers is a dangerous activity. For one thing, there isn't much history for most target date funds. Even more important, a comparison of returns by target date years will be driven by asset allocation – if equities perform well, the provider with the highest allocation to equities will tend to be top of the pile (and vice versa when equities perform poorly). That doesn't tell you who was "right" or "wrong." What about a measure of risk?

This is not to say that the industry doesn't need better ways to measure performance and I think we will see innovation in this area. While this is still work-in-progress, it is clear that such performance measurements need to look at target date funds as a family, not as individual funds. It is also clear that performance should be based on how well the family does in building retirement wealth, not simply raw return numbers. Expect to hear more from the industry on this topic in the coming months.

Observation #12: Target date funds can't solve all your problems.

I hear some providers say that participants act badly and thus we need to design target date funds with that in mind. For example, participants don't save enough, they take out too many loans, and they spend too much in retirement. Target date providers who make this argument usually adopt more aggressive allocations to compensate for this bad behavior – again, swinging for the fences.

However, I'm not sure we want to design target date funds in this way. It's important to understand typical participant behavior, but I think one should design funds for a realistic but appropriate saver. A target date fund does help solve the one issue that has given participants the most difficulty – building an appropriate asset allocation. But to expect it to make up for shortcomings in savings rates is unrealistic.

Conclusion

A participant in a target date fund, whether through a default or by their own choice, is entrusting the plan sponsor to determine what is the best investment solution on their behalf. This is a serious responsibility; most plan sponsors are still coming to terms with what that means, and best practices are still in the process of being defined. My intention in writing this note has been to help that process, on which the retirement security of so many is likely to depend.

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