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Target Date Funds

Target date funds have grown significantly since their inception. With almost half of 401(k) Participants investing in Target Date Funds (TDFs), it is essential for Plan Sponsors to have a good understanding of how target date funds are structured and the appropriateness of them in your fund lineup. According to Morningstar, assets held in target date funds surpassed the $500 billion threshold in 2013, up approximately $15 billion from the year prior.[1] The features of target date funds, including the diversification across asset classes and automatic rebalancing according to a changing risk profile are extremely attractive to the American worker and have led to the expansion of the funds.

In this edition of Ekon Explains, we shed light on how Target Date Funds are designed and keys factors to consider when choosing to invest in such alternatives.

Overview

A target date fund (TDF), also known as a life-cycle or an age-based fund, is an investment strategy which has a predetermined asset allocation of stocks, bonds, cash, and other investments based on the number of years from the selected target date. With a target date series of funds, investors choose a single age-appropriate investment option as their overall retirement portfolio and each fund is comprised of a diversified mix of investments. The target date is generally associated with the employee's retirement date where the fund is invested more aggressively for younger participants and systematically rebalanced to become more conservative as a participant moves towards their target date. Moreover, target date funds are professionally managed (even if the underlying funds are indexed). Therefore, investors don't have to actively manage their portfolio; experienced investment professionals adjust the allocations overtime. For some target date funds, professionals continue to manage the fund through retirement.[2]

These funds have become popular as the Department of Labor endorsed them as an acceptable Qualified Default Investment Alternative under 401(k) plans in 2007.[3]

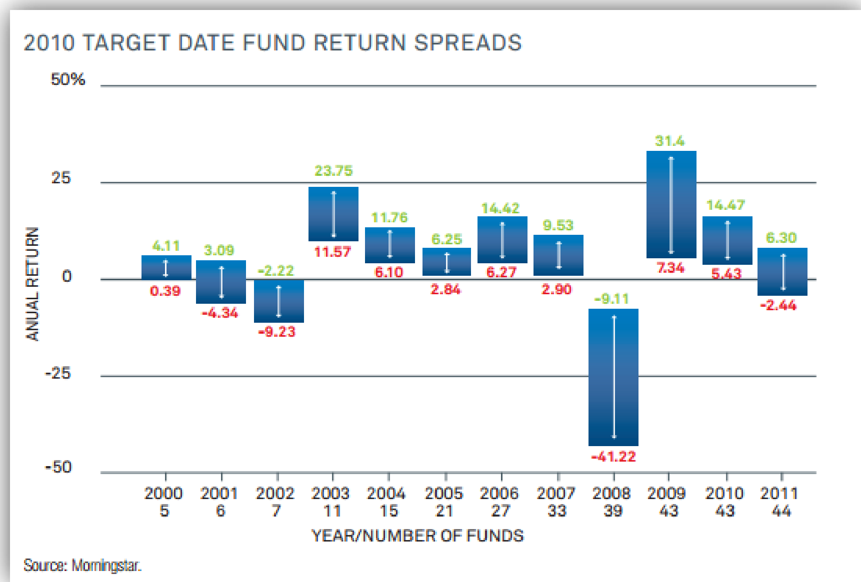
Objectives

Target date funds are designed for two primary objectives. First, the funds assist young investors saving for retirement to achieve higher growth potential over time by starting out with a relatively high equity allocation. Second, the funds aim to reduce the impact of market volatility for investors closer to retirement by gradually shifting to a fixed income focus. However, not all target date funds with the same target year have the same objective. As a result, the risk and therefore the returns vary across different providers of target date funds. Exhibit 1 displays 2010 target date fund return spreads from 2000 to

[1] Schwartz, S. The pros and cons of target-date funds. *CNBC*, 2013.
[2] "A Focus on American Funds Target Date Retirement Series," American Funds, 2012
[3] "Collected Wisdom on Target-Date Funds," 401khelpcenter.com, 2013

2011.[4] The wide variance in annual returns for funds of the same target year results from the different underlying funds in the portfolios.

Exhibit 1



The Glide Path

Target date funds have predetermined asset allocations based on the investor's time horizon which is referred to as the glide path. The glide path explains pictorially how the exposure to equities is reduced as a fund approaches the specific target date. The 2008 market downturn exposed a problem with target date funds: they do not account for the risk tolerance of an individual participant. As a result, some providers have constructed conservative allocations while others maintain more aggressive equity allocations throughout the pre-retirement accumulation period and even into retirement. Every TDF series has its own glide path, risk benchmarks, and overall objectives, as illustrated in Exhibit 2 below.

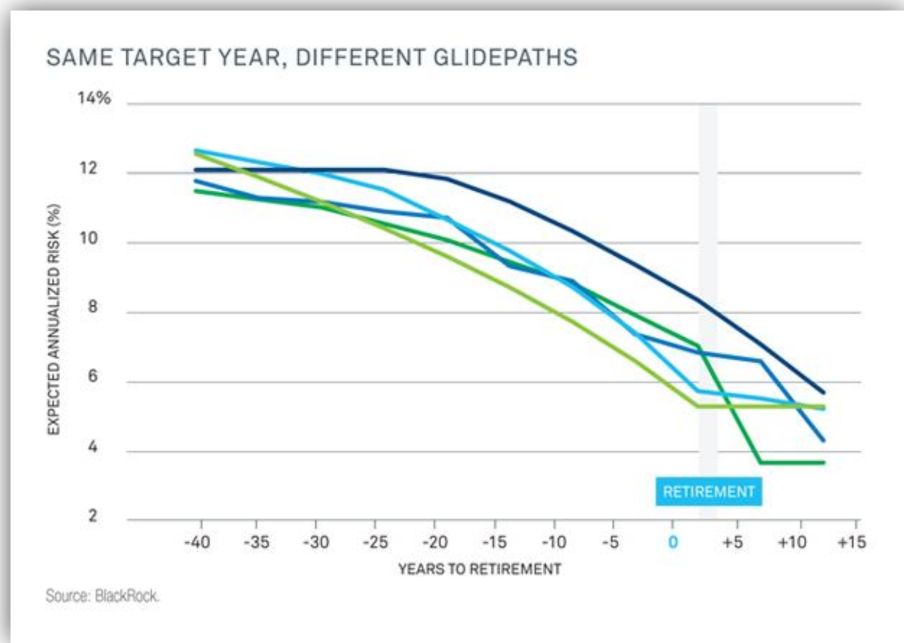
The glide path sets both the investor's initial percentage of equities and the proportion of equities at retirement, as well as the rate at which the equity percentage declines approaching the target date. The mix of other asset classes varies with different providers and allocations can shift through retirement or remain constant again depending on provider. Ultimately, the glide path is designed to achieve the fund's objective of reducing risk corresponding to a shorter time horizon as the investor ages.

Thus, glide paths even with the same target year can take on substantially different risks, with the biggest variance at and into the retirement years. Target date funds with strong

[4] "The Essential Guide to Target Date Funds," BlackRock, 2012

objectives of preserving retirement savings generally have lower exposure to equities than those aiming more to maximize investment capital.[4] Furthermore, glide paths designed to support various withdrawal rates in retirement will have different balances of growth exposure, diversification, and inflation protection.

Exhibit 2



Confidence Levels

With the responsibility of saving for retirement now on the American worker, the Employee Benefits Research Institute conducted a retirement confidence survey and found that only 22% of workers felt very confident that they are doing a good job of preparing financially for retirement. Additionally, only 28% felt very confident they will have enough money to take care of basic expenses during retirement.[5] Since 401(k) plans have become employees' primary retirement savings vehicle, plan sponsors have a responsibility to help the American worker feel more confident about their retirement security.

Determining the Appropriateness of a TDF for Your Plan

Target date funds are seen as a simple, "set it and forget it" investment strategy. Tasks such as rebalancing the asset allocation are no longer the responsibility of the investor, who may not have the expertise to make the proper allocation decisions. Benjamin J. Muchler, the Vice President and Portfolio Manager at Boston Research and Management and a Certified Financial Planner, identifies "simplification" as an advantage of target date funds. "This isn't a magic pill that guarantees a particular return or eliminates the

[5] "Participant Preferences in Target-Date Funds," ING Institute for Retirement Research, 2012

risk of loss, but it brings a level of portfolio management and complexity that is typically out of reach (for most investors)".[6] Fred Reish, a benefits attorney with Drinker Biddle & Reath in Los Angeles comments, "Target-date funds are a much more complex investment than ordinary mutual funds. There are a lot of moving parts."[7] Investors must take into account the risk profile, fee structure and glide path of a target date fund. Since every TDF is different, selecting the appropriate target year is not enough. For example, investors must consider if they want their fund to glide *to* retirement or to continue growing *through* retirement.

Jon Stein, a financial analyst and CEO of financial advisory firm Betterment LLC, evaluates target date funds as being too generic to meet the needs of every investor. "In the context of a 401(k), it's often one of the better hands-off options, but our critique of them is that they are not personalized enough to take preferences into account," said Stein.[8] While being more simplistic and generic has made target date funds a good choice for a Qualified Default Investment Alternative (QDIA), investors should determine if it is the best alternative for their retirement savings.

Stein also argues that fees can be a major issue with target date funds. "Look for low fees. The glide path matters less than fees, because fees are certain to affect your return." TDFs have had a reputation of excessive fees; however, this may be a trend of the past. Morningstar reports that the asset weighted average expense ratio for target date funds is decreasing year-to-year at 1.04% in 2010, .99% in 2011 and .91% in 2012.[6] This may be due to increased watch and proposed regulation from both the Department of Labor and the Securities and Exchange Commission regarding fees and increased disclosure.

Conclusion

Target date funds have advantages and disadvantages just like any other fund alternative. Before deciding if a TDF is right for you, look past the target date and delve deeper into the risk profile, glide path and expense ratio that come with it. Look at the performance of the target date fund with an upcoming target date. Although the market will not be exactly the same, this can still help you get a sense of the glide path and other features specific to that target date fund. As Mr. Muchler of Boston Research and Management said, this is not a magic pill, risk is not eliminated and a particular return is not guaranteed. Ultimately, investors must look at all of the benefits and drawbacks to decide what is best for them and their future.

[6] Lawler, J. Target-date fund pros and cons. *Bankrate*, 2010.
[7] Schwartz, S. How to evaluate target-date funds. *Bankrate*, 2014.
[8] Schwartz, S. The pros and cons of target-date funds. CNBC, 2013.