Target-Date Funds

Participants and plan sponsors continue to flock to target-date funds, for good reason. Rob Capone, Managing Director, Head of Defined Contribution and Sub Advisory at AQR Capital Management; Dan Loewy, Chief Investment Officer and Co-Head of Multi-Asset Solutions at AB; and Rich Weiss, Senior Vice President and Senior Portfolio Manager in charge of Asset Allocation Funds at American Century Investments, explain why. They also look ahead to the ways target-date funds continue to evolve to further enhance Americans' retirement security.

Daniel Loewy, CFA
Chief Investment Officer and
Co-Head—Multi-Asset Solutions
AB

Richard Weiss
Senior Vice President
Senior Portfolio Manager
American Century Investments

Robert G. Capone
Managing Director, Head of Defined
Contribution and Sub Advisory
AQR Capital Management, LLC

P&I: ***Let's start with the history of target-date funds. What need were they created to meet and why have they become such a popular solution for so many plans and participants?***

Rich Weiss: Target-date funds represent a giant leap in the evolution of defined contribution investment and are clearly an enhancement over their predecessor default investment vehicles, money market funds and GICs (Guaranteed Investment Contracts).

They have the features of automatic risk adjustment over the lifetime; professional asset allocation; and broad diversification. Features such as automatic risk adjustment over the lifetime; professional asset allocation; and broad diversification make target-date funds a solid option for those participants who don't have time, the inclination or the sophistication to choose investments on their own.

Rob Capone: Legislation also stimulated the rise of target-date funds. The Pension Protection Act of 2006 was designed to encourage employee savings and, in particular, to lessen the fiduciary burden of employers by creating qualified default investment alternatives (QDIAs). This created a huge opportunity for target-date funds, which have become the QDIA of choice, particularly given the natural ease and convenience of participants' selection criteria.

Dan Loewy: I would add, while they have been offered as a simple, professionally managed solution for the average investor, given the growing size of the default investment in the plan, it's fairly surprising how target-date funds have been slow to evolve into a best-in-class institutionally managed portfolio. That's where we really see them moving over time.

P&I: ***Tell us about each of your firms. What is your firm's philosophy, offerings and approach to target-date funds?***

Rob Capone: AQR is a $141 billion global investment management firm founded on the principles of academic research and innovative investment design. Our focus on practical insights and analysis has made us leaders in alternative and traditional strategies since 1998. In defined contribution, our main goal is help clients achieve long-term wealth creation and preservation. In order to enhance these participant outcomes, we pursue meaningful portfolio diversification through strategies that manage volatility and drawdown potential, but also seek to enhance return over the life cycle of an investor. The firm has and will continue to offer a unique perspective in the retirement industry, providing thought leadership on investment strategies that mitigate the most common shortcomings in target-date portfolios—home bias, inflation sensitivity, concentrated risk, sensitivity to episodes

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>
> ~ Dan Loewy, AB

of equity market turbulence and a lack of highly diversifying alternative strategies.

Dan Loewy: AB is a global investment-management and research firm with $463 billion in assets under management. We are the global leader in custom target-date solutions with over $34 billion of client assets in the U.S., the U.K. and Japan.

We are strong believers in effectively bringing the best of DB plan design into a DC retirement solution. In order to deliver high levels of retirement income over time, our philosophy is to use diversification across multiple managers, non-traditional asset classes, and active and passive strategies. We are also focused on shifting the mindset of the industry and of participants from accumulation to de-cumulation and are delivering solutions that incorporate guaranteed income in an integrated retirement solution.

We will continue to push the envelope to innovate in the target-date space so that we can better meet the objectives of plans and plan participants.

Rich Weiss: American Century is a money management firm. That's all we do. As of January 7th, 2016, we have roughly over $140 billion assets under management. The One Choice Target-Date Portfolios represent a flagship strategy for us. We have over $25 billion in assets in target-date funds and we are one of the few managers with a 10-plus-year track record in this strategy.

If one were to analogize target-date fund investing to a marathon race, which I think is a fair analogy given it's supposed to be a long-term investment strategy, our investment objective is not necessarily to "win" the marathon race. The goal is not to be the fastest runner,

which would be equivalent to having the highest potential return because of a heavy use of equities. That would entail too much risk for most investors. Rather, we aim to run that race at a consistent, steady pace with the goal of having more participants reach their retirement goals.

With a risk-aware group, effective asset allocation and disciplined active management, we seek to provide a smoother ride by limiting volatile return streams. We believe this approach may encourage more participants to stay the course throughout a variety of market environments.

P&I: ***Do you have a preferred glidepath? Can you customize it for the participant base?***

Dan Loewy: We do have a preferred glidepath that we incorporate into our packaged target-date solution. It goes through retirement and incorporates a broad range of diversifying strategies to manage the various risks that participants face across different stages of the cycle. We also believe in customization of glidepaths where we can work directly with the plan sponsor to understand their participant base to help them incorporate a broader range of tools within the target-date funds.

So, for example, for a client that's going to incorporate a lifetime income strategy or an annuity into their target-date glidepath, we will adjust the asset allocation of the overall portfolio as you get closer to retirement.

Also, things like key differences in demographics and income levels can influence our glidepath construction for different plan sponsors. So when you look at our custom business, there can be a wide range of overall equity allocations that we will recommend to a sponsor, depending on the specifics of their plan, their objectives and their company's demographics.

Rob Capone: We don't currently offer our own proprietary target-date strategies. Rather, our strategies fit as sleeves or components within target-date funds. That said, from our perspective, we favor glidepaths that are not cap weighted, but are more risk weighted, and incorporate investment strategies that focus on portfolio risk diversification.

Rich Weiss: American Century's glidepath is, I believe, unique in the industry because it is designed with a flatter slope, which we believe will better balance the various risks that are inherent in life-cyle investing and target-date investing, including longevity risk, market risk, inflation risk, interest rate risk and, importantly, sequence of returns risk.

Additionally, we find that a flatter glide path helps us with our goal of maximizing the Sharpe ratio (or risk-adjusted returns), increasing the consistency of returns and reducing dispersion of returns both across participants over time.

P&I: ***What are your thoughts about using a multi-manager or open source vs. proprietary or single-manager approach for the construction of target-date funds?***

Rich Weiss: The issue of multi-manager vs. proprietary, or open vs. closed architecture, is really a marketing issue. It's descriptive, it is not predictive.

Morningstar has looked at the performance of multi-manager versus proprietary lineups in its annual study on target-date funds. Last year's report once again showed that there is no statistically significant difference in returns between the two categories of managers. (*Source: Morningstar, Inc. 2015 Target-Date Fund Landscape, 7 April 2015.)*

The bottom line is simply that there are some proprietary managers that are better than some multi-managers and there are some multi-managers that are better than some proprietary managers. You just have to look beyond that naïve description to figure who the successful target-date providers are. Each approach has its pros and cons.

Dan Loewy: We've closed all of our own proprietary-only target-date funds and now only offer multi-manager solutions. We think it's best practice.

It's puzzling to us that a target-date fund would really represent the future of retirement savings in America yet be implemented like an investment solution from decades ago. When you look across all pools of institutionally managed assets, one thing that is commonplace is diversification across multiple managers.

From a fiduciary perspective, we also believe that having a multi-manager strategy is superior to a single-manager one. And we're dedicated to changing that space. In fact, the recent Department of Labor "Tips" encourage plan sponsors to consider them.

Rob Capone: We definitely favor a customized, open architecture approach. To go along with Dan's point, using a single manager is a practice you wouldn't see on the institutional investing side. Since open-architecture target-date funds are not limited to a single firm's underlying strategies, they include a mix of different investing styles and seek out best-in-class managers with the goal of delivering increased levels of diversification.

Rich Weiss: I think both of my co-panelists make good points: whether you're a multi-manager or a proprietary offering in the target-date field, you must examine how well your team works together to build a portfolio that has a more consistent stream of returns. And can you achieve diversification across a multi-manager or a proprietary setting?

Again, it's about building a team of managers (proprietary or non-proprietary) that outperforms over time in a steady and consistent manner. Diversification of manager alpha is just as important, if not more important, than diversification of beta in target-date fund construction.

P&I: ***Let's talk in greater detail about the investment components of your target-date offerings. Where do you stand in terms of using non-traditional/alternative investments for target-date funds? Active vs. passive? How about the use of guaranteed products?***

Dan Loewy: Yes, yes and yes.

We do believe that broadening the investment toolkit is a very important activity when it comes to designing a target-date fund. So when we put together our blueprint, it incorporates a broad collection of what we call "diversifiers:" equity diversifiers, inflation diversifiers and fixed income diversifiers. These incorporate a range of different non-traditional liquid strategies that could diversify some of the concentration risk that's in most target-date funds. This is really all about managing equity market risk in the early stage, and then transitions more to addressing interest rate risk at a later stage.
If you can incorporate different diversifying strategies to mitigate some of those risks, and provide a more consistent performance stream over time, that's a clear value-added activity.

In our strategies, we also tend to use a combination of active and passive. Typically, we'll incorporate more passive in the large cap. One of the key requirements for manager selection is to have a process for analyzing the various alternative investment managers and making sure you have access to top strategies, which we do.

We talked about multiple managers, diversifying asset classes, etc. The last piece to the puzzle is a guaranteed income benefit. We believe the future of target-date funds will include some form of guaranteed income benefit. Some sponsors are looking for more explicit guidance from the DOL (Department of Labor) on the guaranteed income front. And we're hopeful if that comes to pass, we'll see much greater adoption of guaranteed income strategies within a target-date solution as well.

Rich Weiss: American Century has a "dynamic," or continuous, process for analyzing new and existing asset classes and strategies for potential inclusion into our target-date lineup. That process includes analyzing all of the usual suspects in terms of investment metrics such as risk and return, correlation or diversification potential, and liquidity, to name a few.

Importantly, the cost effectiveness of the new asset classes is a major hurdle for some of the newer, non-traditional alternative investments to overcome for inclusion in our lineup. We do include an alternative strategy in the form of a 130/30 equity strategy so we've breached the alternative space already.

The cost hurdle applies as well to a guaranteed investment products and annuities. We continue to evaluate those strategies in the context of target-date investing and whether it's cost effective for our clients.

Our one big issue with passive managers is that they put limitations on the diversification potential for target-date funds. Most importantly, I believe the biggest deficiency of the passive approach is the lack of risk control because of their sub-asset class allocation or weighting methodology. Passive target-date funds do not actively manage the relative weightings of such important return and risk drivers as the level of emerging vs. developed equity markets, or value vs. growth stocks, or government vs. corporate bonds. These asset allocation decisions are critical in most other (active) target-date fund strategies for good reason.

Rob Capone: We are in favor of using alternative investment strategies. When I talk about alternatives, I am referring to investment strategies that are daily liquid and daily valued—available in both mutual fund and collective investment trust format.

Liquid alternatives can be an excellent complement to traditional target-date fund structures. They often have different properties than traditional stocks and bonds, allowing them to increase a portfolio's overall expected return, decrease its risk and make it more resilient to different economic environments.

While these strategies behave differently than traditional strategies, they aren't new investments. In fact, they have over a 10-year track record. They've survived rigorous economic tests and have been historically successful on the institutional side. They can be easily implemented within target-date funds as well.

P&I: ***Let's shift a bit to participant and plan behavior. Target-date funds were developed, to some degree, to overcome behavioral biases of participants. But how do you control for recent performance chasing by participants? Analogously, what can be done to improve the decision process of sponsors?***

Rich Weiss: This is a very real issue in the field of investing in general and certainly in target-date funds. This behavioral bias is evident not only at the participant level, but also at the consultant and plan sponsor levels as well.

There are two things that I think that are important for the analysis and evaluation of target-date funds that will help to mitigate those biases.

One is better metrics, and that is to look more at risk-adjusted returns as opposed to just absolute returns. Sharpe ratios would be helpful here, otherwise you're just winding up picking the most recent high return investment, which tend to be high risk with an equity bias.

The other is to ensure that you are looking over a full market cycle. I don't think that there is any investment professional who would advise picking any investment strategy merely by looking at the returns in a bull market. You have to incorporate at least a 10-year window to get a full and fair look to evaluate a target-date fund, to ensure that you're just not naively picking the highest equity or highest risk strategy as the best performer.

In our experience, we've seen a clear deficiency in the way both consultants and sponsors are looking at these strategies in this particular cycle. Historically, five or seven, or even eight years would usually incorporate both sides of a market cycle, but not in this case.

Dan Loewy: First I'd say we still see a real lack of engagement and financial literacy on the part of most participants. That's why the default options, auto enrollment and auto escalation, are so critical to make sure participants are invested in a sound strategy.

Studies have shown that participants within target-date funds, particularly in the younger years, are rarely making short-term adjustments to their holdings within their DC plan. They are effectively sticking with it. That provides an opportunity to reconsider what is the right long-term structure for the target-date fund and not put in strategies that are performance chasers.

To give you an example, one of the strategies that's done incredibly poorly over the last five years, but we think is a critical part of a target-date fund design, is real asset strategies. People are very sensitive to inflation risk as they get closer to retirement.

If through a professionally managed strategy you can put in something that is critical for guarding against future retirement risks, but that participants would never include if left to their own devices because of looking only at recent performance, you're going to provide real value over the next cycle.

We do use a dynamic asset allocation component that provides participants with a risk management strategy that gives the manager the flexibility to adjust the overall equity exposure during periods of high expected volatility and low expected returns. That allows us to mitigate some of the drawdown risks that you face right before you are about to start pulling money in retirement.

Again, a professionally managed solution that is forward looking as opposed to backward looking is really critical to dealing with biases and to getting good results.

In terms of plan sponsors' decision making, it is an education process. You need to be able to show how the portfolio is going to perform over different market cycles. You can highlight the past performance in the context of what was happening in the market to shift the conversation to the risks that need to be managed on a going-forward basis. This allows for a more sophisticated discussion about performance rather than just looking at past three- or five-year results, in designing the strategy for the future.

Rob Capone: What we're seeing is mostly participant inertia. Many participants are not doing much at all. They are defaulted into a target-date fund – they set it and forget it. On one hand, participants may end up lucky if their investments perform well. Alternatively, they may suffer if they are stuck within a strategy that performs poorly, or they are caught in an inefficient portfolio allocation. With that in mind, we favor optimizing the underlying investment strategies within target-date funds to enhance returns and reduce risks over the 40-year investing life cycle.

In terms of plan sponsor decision making, more and more sponsors are turning to consultants to assist in the evaluation of their plans and underlying investment options. Many times, engaging a consultant to assess the goals of the plan vs. the risks can better frame the selection criteria and the potential necessity of using a more custom approach.

P&I: ***You just brought up customization, an important topic. What are the advantages offered by customization? Is there a certain plan size or threshold above which customization makes the most sense?***

Rob Capone: I think the advantage for plan sponsors in a custom arrangement is that they can monitor and adjust the elements within a custom target-date fund, just as they do for other aspects of their DC plan. When you consider target-date fund customization, which I'm a proponent of, the plan sponsor designs a solution that's in the best interest of his/her participants, which is THE primary and ultimate responsibility of the fiduciary.

As far as a threshold, our experience has been that the larger DC plans—those with $250 million in assets or more—tend to engage in more customization of their target-date funds.

Dan Loewy: There are many different reasons why sponsors choose to go custom. One is to have greater control over managers, which gets back to the idea of open architecture. Often, large sponsors will want to utilize many of the same managers they know well from their DB plan and be able to incorporate them within the DC offering.

Second is to have a more diverse asset allocation. Many off-the-shelf providers often just use traditional stocks and bonds and don't have the same type of diversification used in many institutional solutions.

Then there are benefits to a very large plan in terms of costs, fees and transparency. There is also the added fiduciary protection: investment managers are able to remove some of that fiduciary risk from plan sponsors by taking responsibility for the asset allocation and glidepath.

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Lastly, there is the ability to customize the glidepath, designing it for the specific demographics and needs of the plan sponsor.

We see about $250 million or so as the amount of target-date assets where it's clearly a benefit to think about custom. For the middle market, we developed solutions that include all of the key elements of custom design but in a packaged vehicle: multiple managers, non-traditional investments, independent fiduciary looking over the manager selection and a dynamic glidepath.

Rich Weiss: There are roughly 40 target-date providers in the '40 Act world with established strategies and track records. These strategies are publicly available, and run the gamut of "to" vs. "through," open vs. closed, active vs. passive and everything in between.

If there is a case where a plan sponsor and its participants are so idiosyncratic they demand a customized approach, I don't think we have been able to find one that truly is needing of such a level of customization that one of the existing 40 providers couldn't accommodate.

If a plan truly requires a customized approach, they must consider if they have the time and the resources, and importantly, want to take on the potential additional level of fiduciary liability that I believe comes with customization. In the vast majority of cases today – the answer has been no. Customization is simply not worth it.

P&I: ***What are the biggest risks in the current generation of target-date funds? And how do you think target-date funds are going to evolve? What does the future hold for them?***

Rob Capone: Generally speaking, traditional target-date funds that exist today are still subject to the risks that existed back in the 2008 global financial crisis.

Traditional target-date funds generally do not contain investment strategies that reduce home-bias investing, reduce inflation risk, or reduce equity risk concentration. There is also a lack of diversifying alternative investment strategies that can provide sources of return uncorrelated to the existing traditional asset classes.

Despite these shortcomings, target-date funds are definitely here to stay. Callan's DC index stipulates that, as of Q3 2015, more than 70% of DC inflows for their large/mega plan client sample size were going into target-date funds. Target-date funds are now accounting for a little more than 25% of a plan's investment lineup. At that rate of flows, by 2020, the target-date business itself will be over $2 trillion in assets under management.

From a demand standpoint, I don't see the usage slowing down. From a need standpoint and an outcome-based standpoint, I think there will be more custom construction, both in the glidepath and in the underlying investment strategies.

Callan's indices also depict that the percentage of plans using custom target-date funds have risen from 11.5% in 2013 to 22.3% in 2014. Overall, we are in the early stages of seeing more customization and certainly more use of non-traditional investment strategies where the rationale for inclusion is goal based and purpose built to improve participant outcomes.

Dan Loewy: There's a risk that sponsors will hold back the innovation and evolution that is required. Participants deserve a level of investment design and thinking within a professionally managed target-date fund that is up to par with best practices throughout the rest of the investment management industry.

Over the last several years, stocks and bonds have done incredibly well. Going forward, returns look much more challenged. As we look forward, it's really important to think about diversifying across managers, across assets classes, and thinking about a guaranteed income capability as part of an overall solution.

That's where we think the future of target-date investing lies. Again, it is truly in the best interest of plan participants if we think about what strategies are going to provide high levels of income for participants throughout their retired life, which is what the goal of a target-date fund needs to be.

Rich Weiss: In agreement with both co-panelists, one of the major risks is relying on the nature and length of this recent and atypical market cycle to help you forecast or make your decisions going forward for target-date fund selection. It's imperative that we look longer term when we're reviewing these types of strategies, which are intended to be held for years, if not decades, or in theory – an entire lifecycle.

As far as the opportunities go, I think the biggest opportunities are still in the post-retirement or de-cumulation phase. Really, there's only so much at the margin we can enhance in the accumulation phase in terms of diversification and new strategies, glidepath design, etc. I believe the use of guaranteed products that address the longevity risk that's inherent in our demographics today is where the real innovation is going to come from, not only in target dates but for retirement investing in general.❖