WHITE PAPER

Beyond To vs. Through

Next Gen Analysis of Target Date Funds

UNPACKAGING TDFS

Target date funds (TDFs) have simplified the investment selection process for plan participants ever since their creation in 1993. Their invention transformed the defined contribution industry by offering participants access to professional portfolio management and a low maintenance do-it-for-me solution. Today, they are used as the qualified default investment alternative (QDIA) in 86 percent of plan lineups[1] and it is estimated that 88 percent of new plan contributions will flow to TDFs by the year 2019[2]. There has perhaps never in history been a more important investment decision for plan sponsors and advisors.

Due to the proliferation in assets, countless asset managers have entered the TDF space over the past 15 years. One of the most critical decisions each asset manager makes for a series revolves around the construction of the glidepath. The glidepath relates to the asset allocation and is often depicted graphically as the breakdown of equities (or risky assets) and fixed income for each portfolio and how this mix shifts over time.

Managers must balance several key sources of risk when constructing a glidepath. **Market risk** is perhaps the most well-known. Negative performance in the markets can significantly impact portfolio values and hinder the savings of investors. To counteract this, managers can *decrease* the allocation to equities in order to minimize the impact of any market downturn. **Longevity risk** is the other primary factor that must be considered. This represents the possibility that a participant outlives their savings or, in other words, runs out of money before death. To counteract this, managers can *increase* the allocation to equities in order to increase long-term expected return. Here lies the conundrum of every manager and TDF series. What is the optimal trade-off of market risk and longevity risk? What is the optimal trade-off of stocks and bonds?

It is estimated that 88 percent of new contributions to plans will flow to TDFs by the end of the year 2019. There has perhaps never in history been a more important investment decision for plan sponsors and advisors.

[1] Defined Contribution Trends Survey, Callan Investments Institute, 2010-2015 reports
[2] Center for Due Diligence

FINDING THE BALANCE

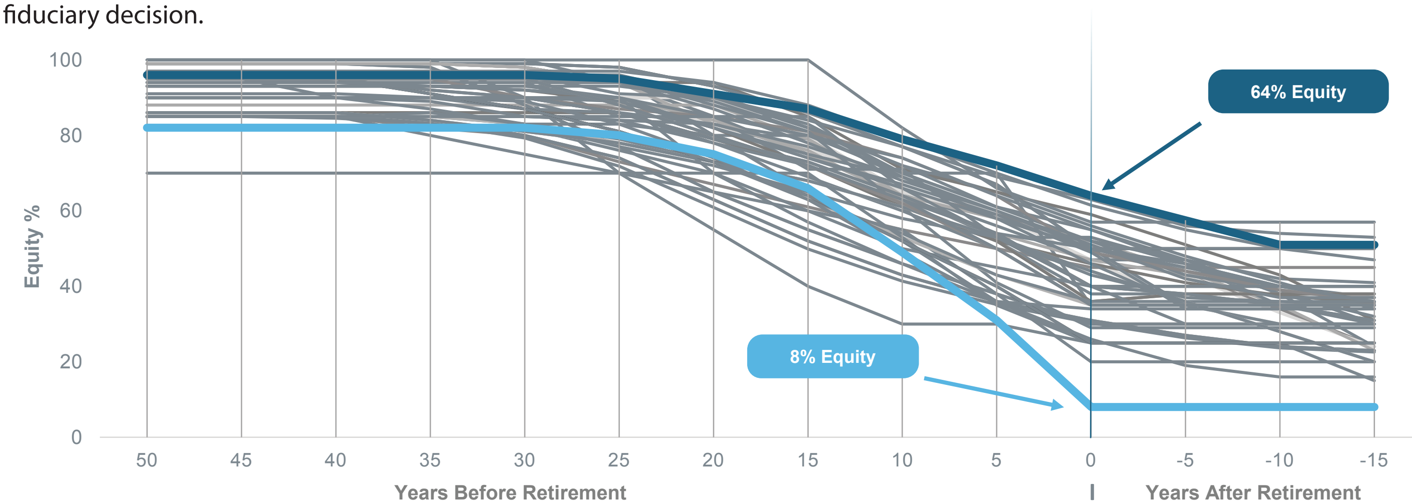
To arrive at the proper balance between these asset classes and ultimately offer participants the best possible chance of a maximal account balance, every TDF manager must make several assumptions about the **capital markets** and **participant demographics**. Capital market assumptions include expected returns of various asset classes, their volatility, and correlations between them. Participant demographic assumptions include the age participants begin saving, their savings rate, salary, retirement age, risk tolerance and access to alternative sources of income such as Social Security. Given the plethora of factors, the various possible sources of data and the numerous calculations managers could use to assign a value to each, it is no surprise that each manager has a different idea of what is an optimal asset allocation and glidepath. For example, all else equal, a manager assuming an average savings rate of 5 percent for participants will have a more aggressive (or equity heavy) glidepath than a manager that factors 12 percent. This additional equity is required to solve for longevity risk by capturing more return over the long term to make up for the shortfall in contributions. In other words, increasing market risk is a way to potentially reach an account balance that adequately funds retirement. For the manager assuming a 12 percent savings rate, the contributions alone are nearly sufficient to adequately fund retirement, therefore additional equity is not required. For this manager, reducing market risk better protects the savings.

	Traditional manager of an aggressive TDF series	Traditional manager of a conservative TDF series
Deferral Rate	Low	High
Employer Contribution	Limited	Meaningful
Account Balance	Low	High
Investor Risk Tolerance	High	Low
Participant Begins Saving	Older	Younger

GLIDEPATH DESIGN

Glidepath design differs so widely today that it's impractical to even place all of these TDF series in one asset class category. Managers agree most on glidepath design at the beginning of the glidepath, but equity allocation still varies by 29 percent from the least to most aggressive series. The range expands as one moves down the glidepath approaching retirement, at which point the difference is **as large as 56 percent**. As one might expect, this difference in allocation can cause significant difference in returns as well. This was shockingly exemplified in 2008, when the best-performing 2010 fund lost 11 percent while the worst-performing 2010 fund lost 42 percent, **a 31 percent difference in a single year's performance**[3].

Adding to this already complicated landscape, plans have never had more TDF offerings available to them, fueled by the trend towards recordkeepers offering open architecture menus and decreasing proprietary requirements. From 2011 to 2015, the number of plans using their recordkeeper's TDF series declined from 70 percent to 30 percent[4]. While this may seem like a positive shift on the surface, the sheer number of available options today leaves many fiduciaries struggling with how to sift through these countless choices, and how to do so in a manner that maximizes the savings of employees while properly documenting this important fiduciary decision.



[3] Morningstar, Inc. Open End Funds, category "US OE Target Date 2000-2010" containing "2010" in fund name, calendar year returns 2006-2010
[4] Defined Contributions Trends Survey, Callan Investments Institute, 2010-2015 reports

DOL Tips for Selecting TDFs:

- Align TDF and participant characteristics
- Understand underlying investments
- Review fees and investment expenses
- Consider custom or non-proprietary options
- Document the process
- Develop effective employee communications

SELECTING TARGET DATE FUNDS

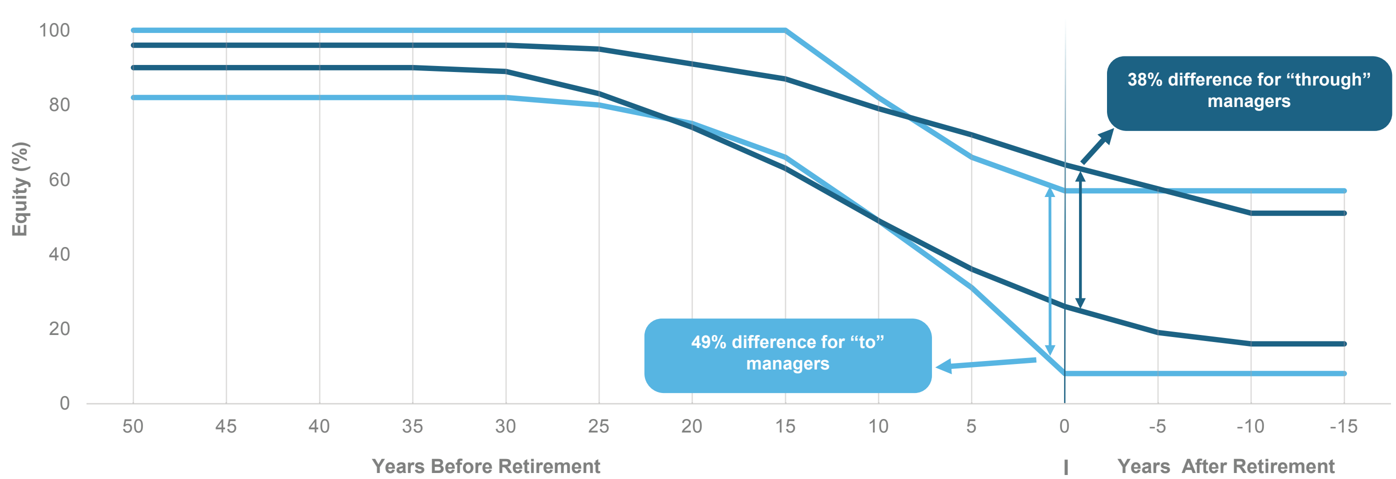
Perhaps due to this increased availability and the shocking disparity of TDF results experienced in 2008, the Department of Labor released official tips for fiduciaries on selecting TDFs.

The DOL did not overly emphasize performance or risk-adjusted performance metrics. **There was a particular emphasis, however, placed on the diversity of glidepath designs and the importance of aligning the TDF's glidepath risk with the participant characteristics of each particular plan.** A practical example of this might be selecting a conservative glidepath for a doctor's office primarily containing employees with high savings rates and a risk-averse mindset. The DOL remarked that one factor differentiating glidepaths is whether they utilize a *"to" or a "through"* approach.

ONE PIECE OF THE PUZZLE

One of the *many* ways that glidepath design can differ from manager to manager is whether the glidepath continues to de-risk beyond age 65 (through) or maintains a static allocation to equities (to). This "to vs. through" debate may be the hottest topic in TDFs, and industry-wide is only second to the "active vs. passive" debate. The differences in approach are obvious–the two clearly result in different glidepath shapes. **With that said, this aspect of a glidepath only takes into account a very small part of the overall glidepath design and level of risk.** It ignores the glidepath prior to age 65, instead only focusing on the post-retirement phase. It also does not account for the actual level of equity exposure, the factor contributing most to risk. The primary reason that "to vs. through" has emerged as the center of the TDF discussion is because it previously served as a proxy for risk. **"Through" glidepaths historically have been more aggressive while "to" were generally more conservative.** Thus, this debate has all along been a debate between aggressive and conservative glidepath design. Many people have used this point to define the level of risk of an *entire* glidepath, when in reality it is a massive generalization. Morningstar confirms this: "The 'to' versus 'through' label is an inadequate proxy for risk. As such, Morningstar analysts do not believe one approach is innately superior to the other."

We previously concluded that overall glidepath design can be quite variable. As displayed in the graphics below, it is evident that *within* these two broad categories of "to" and "through," supreme differences exist. For this reason, it makes more sense to classify glidepaths based on *overall* risk, which stems from the total equity exposure throughout the *entire* glidepath. RPAG has classified glidepaths in this manner since 2009, four years before the DOL tips were even released. Fiduciaries can then pick from a conservative, moderate or aggressive glidepath and better heed the DOL guidance to "align the TDF and the participant characteristics."



"TO" AND " THROUGH" MISCONCEPTIONS

Consider the following scenario: two glidepaths are designed identically right up until age 65, and from there they differ in their approach of "to" and "through." The fiduciaries have already concluded the overall risk of the glidepaths are suitable for the plan in question. So, which glidepath reigns supreme? Below is a review of the objectives of each approach and common misconceptions.

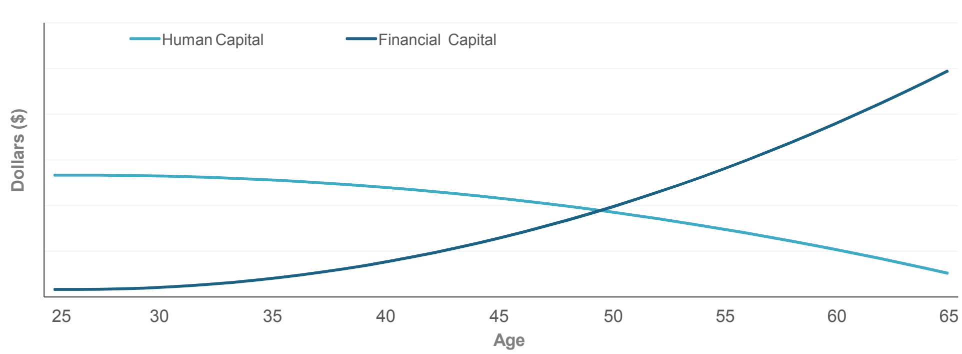
	Through Glidepath	To Glidepath
Function	Continue to reduce equity after retirement.	Reduce equity up to retirement.
Common Misconception	Thought to have higher equity exposure throughout glidepath.	Thought to stop managing the glidepath at retirement, mostly since data shows participants withdraw their account balance at or near retirement.
Clarification	Equity exposure actually varies quite widely depending on series. Some can be more aggressive while others can be more conservative.	"To" managers do not stop managing the glidepath at retirement, but simply maintain a constant equity exposure as an active decision that supports the future income needs of participants.

THE SOUND LOGIC OF "TO"

One of the most common misconceptions in the "to vs. through" debate is that "to" managers stop managing the glidepath after retirement. Following this logic, one might conclude that "to" glidepaths are only suitable for plans with participants that exit the plan at or near retirement. Many advocates of a "to" approach support their viewpoint by pointing to a study indicating that 85 percent of participants pull all of their money out of their account within three years. Conversely, a plan with participants keeping their money in the plan after retirement might make a "through" glidepath seem logical. This logic is flawed.

If just a single participant out of the millions invested in a TDF did in fact remain invested after retirement, wouldn't it make sense to continue managing the glidepath for that one individual? In reality, many participants do, in fact, keep their money in the plan. The glidepath construction decision is made by massive asset managers with trillions in assets and thousands on staff. Companies this large, successful and intellectual would not ignore the needs of the many participants that do in fact end up remaining invested after retirement just because of a generalization that the majority does not. **The prudent "to" manager does not stop managing the glidepath. They rather maintain static equity exposure as an active decision that best supports the savings and distribution needs of participants.** What research and logic supports this approach?

Every participant's total capital is a mixture of human capital (or the potential to earn future income) and financial capital (or current retirement savings). Younger participants are primarily made up of human capital, since their accounts are small and they have a lifetime of wages ahead of them. As the participant ages, this human capital is transformed into financial capital. At the point of retirement, human capital is depleted and financial capital is at its lifetime peak (highest account balance). This makes the day the participant retires one of the riskiest days of their life. Thus the portfolio's risk, or equity exposure, should be at its lifetime minimum. Reducing equity beyond the point of retirement does not make logical sense. Doing so can actually hurt the participant in several ways. In the case of a market downturn, reducing equity would essentially lock in losses. Then the participant would also have less equity exposure in the subsequent market recovery to make up for losses. To make matters worse, future salary contributions are not available to offset these losses. This would all be occurring during the most vulnerable time of a participant's life, since the account is at or near its peak. This is the concept of "sequencing risk," which is predominantly higher for "through" managers during this critical period.



CONTRASTING APPROACHES

In contrast to this conceptually sound approach, prominent managers of "through" glidepaths struggle to produce research and justification that supports their approach. One prominent TDF provider argues that their "through" glidepath is optimal primarily due to a "wealth buffer" (or excess savings) that is created via higher equity exposure in the early years of investing. This explanation completely ignores the actual argument of "to vs. through" since it does not address the point of de-risking *after* retirement. A "to" manager could likewise ramp up equity exposure to try to secure higher performance early on. There are also many "through" managers that take the opposite approach and have lower equity early on. Another leading TDF manager argues that their approach of reducing equity for a few years after retirement before keeping it constant (a to/through hybrid) is optimal. In the case of a market downturn in the beginning stages of retirement, a participant could theoretically re-enter the workforce and make salary contributions to offset losses. This essentially redefines the term "retirement," however, and factors in an unlikely human capital element that most participants will not take. Removing this assumption, it would be interesting to see if this manager would change to a regular "to" glidepath.

The "to" manager does not stop managing the glidepath. They rather maintain static equity exposure as an active decision that best supports the savings and distribution needs of participants.

CONCLUSION

The "to vs. through" debate is one that will likely persist in the industry for years to come, so long as TDFs are as frequently utilized and discussed as they are today (remember, garnering an expected 88 percent of contributions). This argument will likely be perpetuated by individuals who struggle to understand that this aspect of a glidepath is just a part of the overall story of a glidepath's risk. Identifying the proper trade-off of market risk and longevity risk by selecting an *appropriate glidepath for a particular plan* will continue to be a weapon for expert advisors to differentiate themselves and to secure the retirement future of participants. How does offering a glidepath that matches the needs of a group of participants actually help "secure their retirement?" It maximizes the probability that those participants will have adequate account balances and thus a successful retirement. High savers can focus on wealth preservation and narrow the range of possible ending account balances (reducing market risk) since they are already contributing the necessary capital to retire successfully. Low savers can focus on growing their account to widen the range of possible ending account balances (reducing longevity risk) since they need this additional risk due to low contributions. An advisor with an expertise in the TDF landscape can help these participants while enhancing their value proposition in the process.

Identifying the proper trade-off of market risk and longevity risk by selecting an appropriate glidepath for a particular plan will continue to be a weapon for expert advisors to differentiate themselves and to secure the retirement future of participants.

Things to Consider:

- *Risk level of a TDF*
- *Does the risk align with the participant demographics?*
- *Custom or non-proprietary options*

About the Authors

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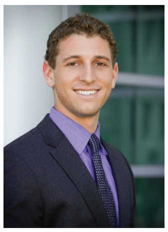

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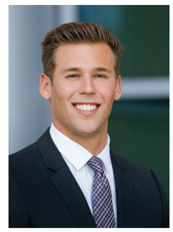

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About flexPATH®

Target date funds (TDFs) have simplified the investment selection process for plan participants ever since their creation by BlackRock in 1993. This invention provided participants with access to professional portfolio management and a low maintenance do-it-for-me solution. Since then, TDFs have overwhelmingly become the primary investment vehicle for retirement plan participants.

The challenge with most TDFs, however, is that in the pursuit of simplicity, the participant has been left behind. TDFs have historically employed a one-size-fits-all strategy of offering a single glidepath, meaning a participant's age is the only factor that determines his or her risk level. While time horizon is an important consideration, it does not account for the different risk preferences of participants of the same or similar age. The innovative, multi-glidepath approach of flexPATH helps solve this challenge by giving participants the powerful ability to select not only their time horizon, but also their risk level (conservative, moderate, or aggressive). While TDFs typically offer sufficient diversification across asset classes, the proprietary nature of many TDFs may lower the quality of the overall portfolio by limiting underlying management to a single money manager. Once again, flexPATH takes a different approach by incorporating an independent and open architecture underlying fund selection process that provides unparalleled access to best-in-class managers.

Having all of this packaged together in a low-cost collective investment trust (CIT) format, flexPATH maintains the simplicity and ease of use of a traditional TDF while adding intensified oversight and a higher fiduciary standard via three leading and independent organizations. The result is the industry's most sophisticated, yet participant friendly target date fund solution.

With flexPATH, investment management is delivered in either a fully passive approach (Index) or a core-satellite approach (Index+). The glidepath needs of all plan participants are addressed with the availability of a conservative, moderate and aggressive glidepath. After selecting the closest year (2025, 2035, 2045, or 2055) in which the participant expects to retire, consider both their comfort with risk as well as the amount of risk needed to accomplish their retirement goals when selecting the most appropriate retirement PATH.

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