



The Evolution of Target Date Funds: The Benefits of Custom Asset Allocation While Minimizing ‘Future Regret’

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Since their inauguration roughly 10 years ago, target date funds have become a fundamental part of most defined contribution retirement plans. The fund’s appeal is largely due to the fact that they require almost no initiative on the part of participants to construct and maintain retirement portfolios. Participants simply choose a fund that most closely matches their desired target retirement date and their asset allocation “autopilot” is engaged.

The risk profile of a target date series is basically controlled through an age-based pattern of equity exposure. Funds having a target retirement date further in the future will have a greater allocation to equity than those funds with target dates in the near future. As each fund nears its target date its equity allocation will automatically be reduced. This gradual reduction in equity over time is commonly referred to as a fund’s glide path. Consideration of factors such as time horizon, risk tolerance, savings rates, projected income needs during retirement and participant assets outside the retirement plan are assumed to be for those of an “average” investor in the construction of a portfolio for a particular age group.

The popularity of these funds among participants – combined with an endorsement as a “Qualified Default Investment Alternative” by the U.S. Department of Labor – provides plan sponsors with a compelling opportunity to make a positive difference in the participant’s savings behavior towards reaching his or her retirement savings goals. But why stop with a one-size-fits-all approach?

Increasingly sponsors of larger plans have been taking the next step in the evolution of target date funds by adopting custom target date strategies.

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Advantages of moving to custom strategies include the following

- QUALITY OF INVESTMENTS/TRANSPARENCY – Many off-the-shelf target date funds are criticized, and rightfully so, for using only proprietary funds as the underlying investments for their target date portfolios. This approach is considered sub par as no single investment firm can provide a “best-in-class manager” in every underlying asset class. Additionally, there is no way that a plan sponsor could replace an underperforming manager without getting rid of the entire target date fund series. Simply put, custom strategies allow plan sponsors greater control over the quality of funds in their target date portfolios.



Transparency is also improved using custom target date strategies, which generally allow both the plan sponsor and participant to easily identify underlying funds and their allocation and rebalancing schedule.

- **EXPENSE** – Custom portfolios are typically constructed from a plan’s core array of funds. This design feature allows plan sponsors to leverage their asset base to gain access to lower cost institutional share classes, which translates directly into higher returns for participants.
- **STREAMLINED FIDUCIARY OVERSIGHT OF PLAN INVESTMENTS** - It’s not uncommon for a plan’s menu of funds to increase by 10 or more when off-the-shelf target date fund families are selected. As a result, the burden of investment oversight for plan fiduciaries may be greatly increased. To the contrary, custom strategies often leverage the fiduciary oversight processes already in place for a plan’s core array of funds. This saves the plan sponsor time and money when monitoring fund investments.
- **PARTICIPANT DEMOGRAPHICS** – Custom strategies allow the plan sponsor to tailor their glide path and asset allocation to better fit the demographics of their participants. Demographics such as average age, tenure, savings rate, income level and volatility of income provide insight into the risk capacity of participants. Generally speaking, participants with a lower risk capacity are likely to be better off with a target date fund having a lower allocation to equity. No matter how well thought out an investment strategy, its success in the real world is dependent on keeping participants invested and making contributions through market downturns. The riskier the strategy, the more likely it will be abandoned during a year like 2008.

Even experts are subject to emotion when making investment decisions that, as one might expect, are largely tied to their risk capacity. The following excerpt

is from a question posed to Dr. Harry Markowitz regarding how he personally diversifies his own portfolio. His comments can be found in the January 3rd, 2009 *Wall Street Journal* article titled “Investing Experts Urge ‘Do as I Say, Not as I Do’”

“Following his own breakthroughs, he should have made intricate calculations, based on historical averages, to find the optimal trade-off between risk and return. But, Dr. Markowitz told me, that isn’t what he did: ‘Instead, I visualized my grief if the stock market went way up and I wasn’t in it—or if it went way down and I was completely in it. My intention was to minimize my future regret.’

“Dr. Markowitz paused, then added wryly: ‘So I split my contributions 50/50 between bonds and equities.’”

(Dr. Harry Markowitz is best known for his pioneering work in Modern Portfolio Theory (MPT), and in 1990 he was awarded the Nobel Memorial Prize in Economic Sciences.)

According to a September 2008 survey by the AARP, one in five middle-aged workers stopped contributing to their retirement plan in the preceding 12-month period. Those participants were likely taking steps they believed would minimize their future regret.

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Custom target date strategies allow plan sponsors to better serve their participants with an asset allocation glide path that is more closely aligned to their risk capacity.



ity, which mitigates the chance of unpleasant surprises, especially towards the end of their retirement savings period.

- **PARTICIPANT COMMUNICATIONS** – There has been a great deal of criticism leveled at target date funds for the disparity of returns produced by funds near their target date during 2008’s market melt-down. This disparity by in large represents a difference in the underlying philosophy of the target date fund providers. Some target date providers have designed their funds to get participants to retirement and as a result generally have lower “landing allocations” to equity. Other providers have designed their funds to take participants through retirement and believe higher allocations to equities are necessary to achieve this goal.

Recently consensus has been building that the problem is not with differences in philosophy, but it is with the naming convention the mutual fund industry has adopted for the funds, e.g. the equity exposure for target date funds with 2010 in their name currently ranges from 15 percent to 62 percent among various fund families. Given that the funds are advertised as being age appropriate, it is easy to understand why many participants in the higher equity funds were surprised by their fund’s poor performance in 2008. The range of returns from this group of 2010 funds in 2008 was down 9.5 percent to -41.3 percent.

This concern has prompted the SEC to issue proposed amendments to regulations governing

marketing materials for target date funds. The heart of the proposed changes require improved disclosure of the funds’ asset allocation among different types of investments, renaming of the funds and statements describing the funds’ glide path, final allocation and risks.

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- **ALLOCATION TO ALTERNATIVE ASSET CLASSES/ TRADING STRATEGIES** – An April 2009 survey by the Profit Sharing Council of America asked plan sponsors why they chose to develop a custom series. The top two reasons were, “The ability to create a more diverse asset allocation,” at 29.6 percent, and second, “Control over underlying managers,” at 27.3 percent. Earlier we addressed the advantages of control and the advantage of aligning the target date strategy to a participant’s risk capacity. In addition to con-

Annual Returns 2008				
Traditional Stocks		Alternatives		
U.S Equity S&P 500 index	International Equity MSCI EAFE index	MSCI US REIT NR USD	Commodities DJ Commodities Index	Long/Short Equity Morningstar Long/Short Equity category average
-37.0%	-43.4%	-39.1%	-35.7%	-15.4%

The above table shows the annual return of several core asset classes and alternative asset classes during 2008’s market meltdown. From the data it is obvious that correlations increased in 2008 among several of the asset classes shown, including alternatives such as commodities and real estate. However, alternative trading strategies such as long/short equity provided investors with meaningful downside protection.



trolling a target date strategy's allocation to equity, plan sponsors of custom funds may add alternative asset classes/trading strategies to their allocation to mitigate risk. Plan sponsors concerned with the risk capacity of their participants are free to employ alternatives of all types in their custom allocations sooner rather than waiting for fund companies to warm up to the idea.

At Bidart & Ross our philosophy toward building customized strategies for plan sponsors is centered on keeping participants invested and making contributions during the best and, more importantly, the worst of times. We believe plan participants are best served when the allocation of their target date strategy is as much concerned with, in Dr. Markowitz's words, "minimizing future regret" on the downside as it is with return generation.

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