Benchmarking Target Date Funds

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I. Introduction

It is no secret investors are increasingly responsible for funding their own retirements. It is also clear that this is a huge responsibility. Beyond the difficult job of just saving enough, investors must deal with asset allocation decisions, investment performance monitoring, market volatility, inflation, lengthening life-spans, and evolving individual risk preferences.

Thankfully, the investor's situation has not gone unnoticed. The financial services industry has developed target date, or lifecycle, solutions to provide investors with asset allocation, security selection, and automatic risk reduction in one package to help investors address their retirement funding challenges.

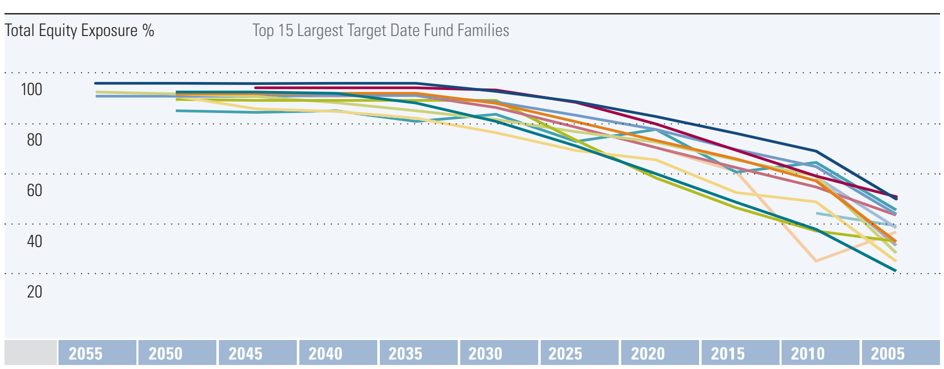
The logic behind the target date solution is driving wide-spread adoption and strong asset growth. The Department of Labor has designated it as a default investment option, in addition to managed accounts and balanced funds, that companies can select for employees when appropriate. Plan sponsors also see the value of the target date solution and are choosing it by a wide margin. A recent Deloitte survey finds that target date funds are the default option at 63% of the surveyed firms, with balanced funds the second-most popular choice at 15% (401(k) Benchmarking Survey, 2008 Edition, Deloitte Consulting LLP). Target date fund assets are growing quickly in response to these endorsements—nearly $250 billion in assets under management in late 2008, up from just $27 billion in 2003 (Morningstar Direct).

With the industry opportunity that's linked to such strong asset growth comes the responsibility to provide scrutiny and benchmarking guidance to the target date market. Expanded fund portfolio analysis and specialized fund family metrics are industry developments that should emerge in the near-term for the benefit of individual investors, plan fiduciaries, and fund manufacturers.

Benchmarking target date funds is, at first blush however, a contradictory exercise. Each fund has a different age-based risk control solution called a glide path. The key component of this risk control mechanism is the automatic shift of the asset mix from equities to fixed income over the investment horizon. While the concept of risk reduction over an investor's career is quite sound, the methodologies behind the glide paths are varied. This leads to substantial glide path differences, making comparisons difficult.

And yet glide path diversity is a good thing – it is universally accepted that investors have different risk capacities, tolerances, retirement goals, and financial situations. Indeed, the natural development of a wide range of glide-paths observable in today's target date fund marketplace underscores this point.

Exhibit 1: Glide Path Diversity in the Marketplace



Source: Morningstar Direct

The difficulty is that a retirement plan typically selects only one fund family, and therefore only one glide path, for all its investors. We think it would be appropriate for the industry to evolve to a point where investors have more glide path choice, so they can keep their investments in sync with their evolving risk capacities and preferences.

Retired and roll-over investors on the other hand are able to pick from a larger set of target date fund families. These investors would benefit from a richer set of risk-assessment and fund selection tools. We believe the industry will quickly respond to this need. Investors and advisors should soon have several enhanced fund family reports and risk assessment tools to help them make informed decisions.

Given the importance of target date funds to the financial security of an increasingly large number of investors, there is an inadequate number of target date benchmarks. The target date market has grown from almost nothing six years ago to $250 billion in assets today, managed by nearly 40 fund companies. And Morningstar expects target date assets under management to double during the next 3 years as companies continue to adopt auto-enrollment and overwhelmingly select the target date solution as the default investment choice. Fund companies and fiduciaries meanwhile have a natural incentive, beyond the regulatory obligation, to understand target date investment best practices as they evolve to meet their customers' needs.

Current Target Date Benchmarking Approaches

Current target date benchmarking efforts designed for individual investor consumption usually involve a comparison to a single-asset class index such as the S&P 500, a generic "60/40" blended index, or to a target risk index. The lack of a glide path or adequate asset-class representation leaves these benchmarks ineffective however for individual or advisor use.

Target date benchmarking by fund manufacturers is typically more robust, but it's usually designed for internal management more than for fiduciary use. Fund manufacturers typically plug benchmark investments into their asset allocations to set baseline expectations for their asset allocation methodology. Firms then plug their security selections into the benchmark asset allocation to isolate and measure the robustness of their security selection process. There is usually no report from the fund manager that compares its asset-class diversity, or risk control methodology, or security selection ability to peers or a well-crafted benchmark.

Morningstar's Philosophy

We think the target date benchmarking challenge can be approached by breaking a fund down into discrete pieces. Target date methodologies can be split into three key components that can be evaluated separately. Each component can be scored independently to assess the quality of the fund. An overall fund family rating can then be assembled to support advisor and plan sponsor due diligence efforts:

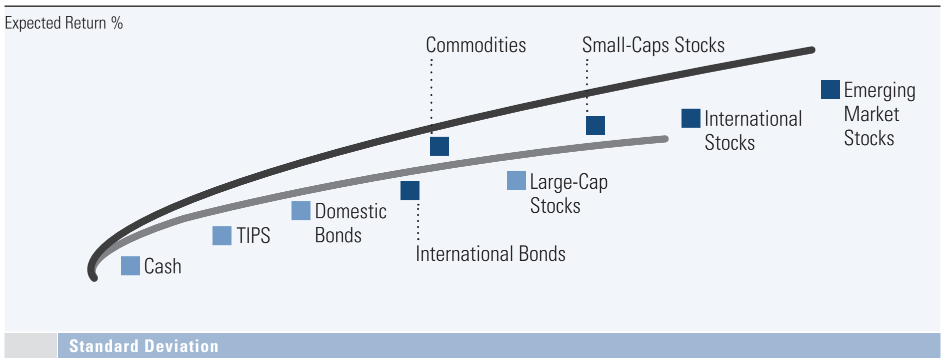
- *Asset class diversity*—the quality of the portfolio, relative to a desired risk profile, based on asset-class diversity and the allocation optimization process.
- *Security selection*—how a target date fund invests to capture the essence of an asset class covers several areas, such as active vs. passive, direct investment or fund-of-funds structure, degree of intellectual capital diversity (do all the ideas and economic assumptions come from one fund family's research department?) and asset-class performance, net of fees.

▸ *Risk control*—the methodology that adjusts the asset allocation to synchronize the portfolio's risk profile with that of the targeted investor risk profile over the investment horizon; commonly called the glide path.

Asset Class Diversity

Time-tested financial theory has established how diversification improves an investor's portfolio. Measured additions of bonds to a stock portfolio or international securities to a domestic portfolio are allocation decisions that can improve the expected risk/return characteristics of a portfolio. In Modern Portfolio Theory, the optimal set of asset allocation mixes for a particular set of asset classes is called the Efficient Frontier. The goal is to move the efficient frontier up and to the left via asset class diversification. Exhibit 2 illustrates how adding some asset-class diversity to a portfolio can achieve this goal.

Exhibit 2: Asset Class Diversity Can Improve the Efficient Frontier



For illustrative purposes only

Source: Ibbotson Associates

A first-class target date fund should, by definition then, start with the best set of building blocks possible. The major asset classes in terms of target date fund relevance are listed below:

▸ *Stocks*—a cornerstone asset class, the unlimited upside potential of equity helps investors achieve some of the most robust asset growth possible to help reach investment goals and fight inflation. International equity, covering developed and emerging markets, is a related asset class that provides the benefits of equity ownership in companies with economics that are typically not highly correlated to an investor's home-country stock selections.

▸ *Bonds*—another cornerstone asset class for retirement investors, bonds represent an ownership interest in a debt that pays interest. A lower risk, lower return investment relative to stocks, bonds typically become an increasingly important asset class in the portfolio as the investor advances in age and needs a reduction in market risk. International bonds represent the same basic asset class properties, but differences in interest rates and currency exchange rates provide an element of uncorrelated fixed income returns that help overall portfolio diversification.

▸ *Commodities*—while not a cash-flowing asset class in the classical sense, a commodity-linked investment is a relevant addition to an individual's portfolio because it provides diversification relative to stocks and bonds.

▸ *Real estate*—the real estate asset class is typically represented by REITs given the complexities of pursuing direct real estate investment in a tradable product. The real estate asset class can be an isolated allocation or included in the stock allocations, per the security selection process.

▸ *TIPS*—Treasury Inflation-Protected Securities are government bonds with principal payoffs at maturity that are adjusted for inflation, making them a key allocation to retirement portfolios in later years.
▸ *Cash*—the minimal returns generated by this asset class are quickly eroded by inflation. Quality target date funds will ideally keep cash allocations to the minimum required to maintain operational liquidity.

The quality of the capital market assumptions used to calculate allocations to each asset class represents an equally important area to consider beyond asset-class diversity. These assumptions are fed into a mathematical tool that optimizes the various asset classes to create the portfolios. Stale or uninformed asset class assumptions will lead to sub-optimal portfolios. The pedigree of the firm providing the capital market assumptions, and the process used to refresh them, are two areas that should be assessed when evaluating target date fund quality.

Security Selection

Security selection to represent each chosen asset class is another major evaluation area for target date funds. Fund managers can select an active approach, where the best securities for each class are hand-picked, or a passive approach, with a rules-based index selecting the securities.

Evaluating a target date fund's approach to security selection should focus on risk-adjusted returns, net of fees. Measures such as Sharpe ratios, information ratios, or weighted average manager alpha, compiled over an appropriate timeframe, should be used to help determine if a fund's security selection process adds value. Detailed attribution analysis will also be helpful. At a minimum, the security selection process should capture the beta of the asset class, as measured against an appropriate benchmark.

One frequently mentioned obstacle to measuring target date fund performance is the lack of track records for most funds. It is possible to measure the quality of the ingredients going into the fund however. Many target date funds are simply allocations to existing funds with track records. These underlying funds can be evaluated across a number of different performance properties and those evaluations can be combined to provide a useful mosaic of information about the target date fund family under review.

Risk Control

Investors saving for retirement typically become more risk adverse the closer they get to retirement—which is wise. Their retirement nest egg represents a key source of retirement income and any impairment to that nest egg isn't easily fixed at this stage.

Levels of risk preference will vary among retirement investors however. Some investors will have well-funded pension plans and generally secure retirements. Others will be severely underfunded at retirement. Some will spend half their career in one situation, and due to a number of reasons, end up unexpectedly in the other situation.

The risk control program, or glide path, simply represents an effort to synchronize the fund's risk profile with a modeled investor risk profile. The glide path typically does this by reducing the market risk of the target date portfolio over the fund's investment horizon.

Because risk-profile diversity among investors is unavoidable, glide path choice is essential. Target date funds today contain many different types of glide paths. Some dip steeply at retirement and then flat-line to provide as much protection as possible when account balances are the highest. Others slope gradually, well past the retirement date, to keep the portfolio growing as much as prudently possible.

The challenge is that most target date fund families only offer one glide path for all investors. Unfortunately, when fund families only have one option they tend to adopt the defensive stance that their glide path is the best for all investors. This often prevents a more constructive dialog around which type of fund is most appropriate for a particular investor. Fortunately, as with most rapidly growing areas, segmentation is expected. We believe glide path choice within a given target date fund family will be a helpful industry development for investors. Some investors will appreciate a conservative glide path option to offset a low capacity for risk, perhaps due to employment in a volatile industry, or a simple desire to select a risk level that lets them sleep at night. Other investors will likely appreciate an aggressive option that promotes asset growth well into retirement to offset longevity risk or support a bequest objective.

Conclusion

Target date funds are difficult to benchmark in the traditional sense because of the glide path diversity in the marketplace that has developed to meet the needs of a wide range of investors. That shouldn't stop the financial services industry from evaluating other key areas of the fund—asset class diversity and security selection. The stakes are too high to let quality control lag marketing and product development.

Fiduciaries and individual investors ultimately need tools with several attributes to help with this evaluation. They need benchmark indexes built to reflect the multi-asset-class and risk-shifting nature of target date funds. Investors also need the ability to evaluate the asset-class and security-selection components separately to understand the quality of each piece. Glide path evaluation should also be a discrete process to ensure the fund's risk control methodology matches the objectives of the targeted investor segment.

We expect market forces will create these types of evaluation tools. The increased scrutiny provided by these tools could lead to target date fund consolidation in the marketplace. Investors however will benefit handsomely from the subsequent increase in product quality and selection advice.