Target Date Funds:
"To vs. Through" Retirement Glidepath Construction

Jeri Savage
Equity Research Associate

THERE HAS BEEN EXPLOSIVE GROWTH IN THE TARGET DATE INDUSTRY FOLLOWING THEIR DESIGNATION AS A QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) IN 2006. HOWEVER, NOT ALL TARGET DATE FUNDS ARE CREATED EQUAL AND THE GROWING NUMBER OF OPTIONS NECESSITATES INCREASED PARTICIPANT EDUCATION. THIS PAPER WILL FOCUS ON GLIDEPATH CONSTRUCTION AND THE DISTINCTION BETWEEN FUNDS MANAGED TO RETIREMENT COMPARED TO THOSE MANAGED THROUGH RETIREMENT.

INTRODUCTION

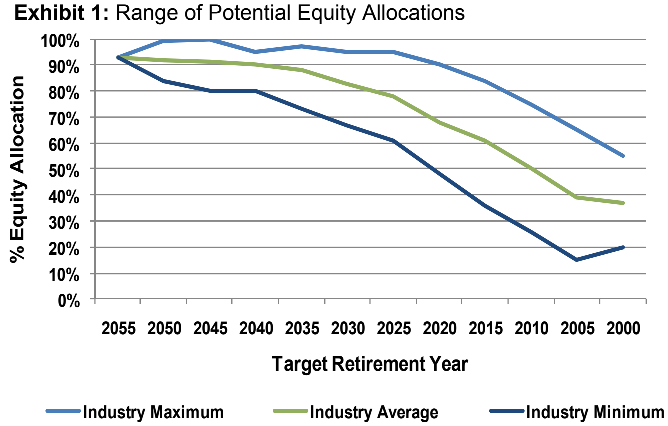
Since target date funds were designated as a Qualified Default Investment Alternative (QDIA) under the Pension Protection Act in 2006, the usage and prevalence of target date funds has skyrocketed. For example, the 53rd Annual PSCA Survey of Profit Sharing and 401(k) Plans reflects 2009 data on target date fund usage. The annual survey is based on 931 plans with 8.6 million active participants and $628 billion in plan assets. According to the recent survey, target date fund availability ranged from 57.5% in plans with 50-199 participants to 67.2% in funds with 5,000+ participants and averaged 62.3% for all plans. Although target date funds are now in a large percentage of plans, the dollar amount invested in target date funds is low, but growing. For all plan assets, 7.7% of total plan assets were invested in target date funds. With respect to the type of target date funds in each plan, 91.3% of plans with a target date fund are using a packaged product, compared to a customized option or combination of the two. In addition, 38.4% of plans have an automatic enrollment feature and the automatic default option for automatic deferrals is a target date fund in 57% of plans.

WHY THE RECENT SCRUTINY

Target date funds have received more attention following the market environment in 2008. By the end of 2008, the universe of 2010 target date funds showed a range of returns from -5% to -30% and it left many people confused since these funds are designed to become more conservative nearing retirement[1]. The average annual return in 2008 for the Morningstar Target-Date 2000 – 2010 category was -22.46%.

The dispersion of returns in 2008 highlighted the range of equity allocations for similarly dated funds in the target date fund space. As Exhibit 1 depicts, there is a wide band of potential equity allocations among funds that now exist in the target date space. Funds with the same target date can have very different asset allocations, management styles and glidepaths. For example, Morningstar notes the industry average equity allocation for 2010 funds was 50% as of December 31, 2009. However, the industry maximum was 75% and the industry minimum was 26%, quite a difference among funds all labeled 2010.

Exhibit 1: Range of Potential Equity Allocations



Source: *Morningstar's Target-Date Series Research Paper: 2010 Industry Survey. Data as of 12/31/2009.*

The issue led to a joint Department of Labor and Securities and Exchange Commission hearing in June 2009 and, following that hearing, a target date fund Investor Bulletin was issued in May 2010, an SEC Proposed Rule was issued in June 2010 (expected to be finalized by early 2011) and it is widely anticipated that a Fiduciary Best Practice Checklist with respect to target date funds will be issued by the end of 2010[2]. The general consensus is that the industry will continue to evolve and communication about fund specifics should be improved.

[1] DC Focus: Keep Your Eye on the Target. *Target-Date Funds: Getting Back on Point*, Betsy Massar, Fall 2010.

[2] Fiduciary Best Practices in Target Date Funds webinar, October 27, 2010.

TO VS. THROUGH RETIREMENT DEFINED

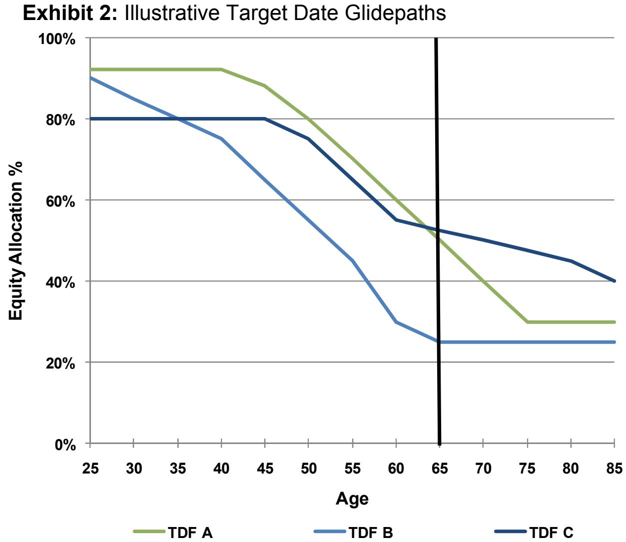
The increased scrutiny and differing glidepaths have opened up the popularly coined debate, "To versus Through." This shorthand terminology relates to a target date fund's glidepath and is meant to answer the question of how that target date fund's equity allocation is managed, to or through retirement.

The Investment Company Institute (ICI) defines "to versus through" in the following manner: "To" funds are designed for an investor who expects to spend all or most of his money in the fund at the target date. "Through" funds are designed for an investor who plans to withdraw the value of the account in the fund gradually after retirement[3].

Simply put, glidepaths managed "to" retirement assume retirement is the end date. At and post-retirement, the underlying allocations remain static going forward. Conversely, glidepaths managed "through" retirement continue to adjust past the designated retirement date. Typically, the allocation to equity continues to decrease.

Exhibit 2 illustrates three target date funds with different glidepaths. Target Date Fund B is managed "to" retirement with a static equity allocation at and post-retirement. The other two target date funds depicted are managed "through" retirement. Past age 65, both "through" retirement funds continue to decrease their equity allocation.

Exhibit 2: Illustrative Target Date Glidepaths



MARKET RISK VS. LONGEVITY RISK

Target date funds that are managed to retirement are generally managed to address market risk, which is the risk of a market decline depleting assets. Target date funds managed through retirement are managed to address longevity risk, which is the risk of outliving one's assets. Therefore, funds managed to retirement focus on minimizing the loss of principal in retirement while funds managed through retirement maintain an adequate income stream throughout retirement[4].

Target date funds managed "to" retirement display a number of characteristics. The target date fund is managed to a specific endpoint (retirement), at which point the belief is that the participant is likely to withdraw from the plan. With the retirement date as the endpoint, the fund's equity allocation tends to be more conservative at retirement compared to funds managed through retirement. Funds managed to retirement also tend to be more conservative before retirement compared to funds managed through retirement. These points are reflected in Exhibit 2.

Conversely, target date funds managed "through" retirement often display an opposite set of characteristics. The glidepath of a fund managed through retirement continues to adjust post-retirement based on the belief that participants will not make sharp withdrawals at retirement. With adjustments made post-retirement, the fund's equity allocation tends to be more aggressive at retirement compared to funds managed to retirement. The post-retirement rolldown period for through retirement managed funds varies across managers. Again, these points are reflected in Exhibit 2.

THE TARGET DATE FUND UNIVERSE

As of Q3 2010, Ibbotson, a subsidiary of Morningstar, was tracking 362 unique target date funds with at least a one-year track record, representing 42 fund families[5].

Our analysis uses the Morningstar Target Date Universe, which is divided into nine peer groups, ranging from the Target Date 2000-2010 Universe to the Target Date 2050+ Universe. The raw data in the total universe lists 1,939 individual funds, which we narrowed down to 1,619 funds by eliminating all closed and not active funds. We then only considered distinct fund family names so as not to double count a target date fund that may be offered through different share classes and disregarded multiple vintages for the same target date fund family. For example, we consider the Fidelity Freedom Funds to be a single target date offering, rather than counting the Fidelity Freedom 2020 Fund and Fidelity Freedom 2030 Fund separately. The resulting Morningstar universe of distinct fund families offering target date funds is 40 fund families. We added in State Street Global Advisors (SSgA), which offers a target date product through collective funds and is not in the Morningstar universe, to bring our total to 41 managers.

[3] ICI Principles to Enhance Understanding of Target-Date Funds, June 18, 2009.

[4] Pension & Investments: Revisiting the 401(k) Investment Lineup Summit. *To vs. Through: Which Glidepath is Right for You,* Jerome Clark and Wyatt Lee of T. Rowe Price, April 22, 2010.

[5] Ibbotson Target Maturity Report, Q3 2010, October 28, 2010.

We found that 16 of the 41 target date fund products are managed "to" retirement; this represents 39% of the total universe. Conversely, the remaining 25 managers with target date fund products manage their glidepaths "through" retirement, representing 61% of the universe.

A LOOK AT THE LARGEST FUND FAMILIES

As of 2009, target date mutual fund assets were $256.5 billion[6]. The 15 largest fund families represented 96.8% of industry assets; the top three providers, Fidelity, Vanguard and T. Rowe Price, represented over 75% of industry assets[7].

A narrowed down look at the 15 largest fund families demonstrates similar statistics found for the total target date fund universe as noted above. As shown in Exhibit 3, six managers manage the glidepath "to" retirement; representing 37.5% of the top managers and ten managers manage the glidepath "through" retirement, representing 62.5%. Please note that John Hancock offers both to retirement and through retirement strategies, creating a dataset of 16 observations.

Also interesting to note, the three largest managers, Fidelity, Vanguard and T. Rowe Price, all offer target date funds that are managed "through" retirement.

Exhibit 3: The 15 Largest Fund Families

Fund Family	To vs. Through	Rolldown in Years
AllianceBernstein	Through	15
American Century Investments	To	0
American Funds	Through	30
BlackRock	To	0
Fidelity Investments	Through	10-15
ING Retirement Funds	To	0
John Hancock	To and Through	0 and 20
JP Morgan	To	0
Mass Mutual	Through	15
Principal	Through	15
State Farm	To	0
T. Rowe Price	Through	30
TIAA-CREF	Through	10
Vanguard	Through	7
Wells Fargo	Through	10
Number of To Retirement Managers		**6**
Number of Through Retirement Managers		**10**

**Note: John Hancock offers both to and through retirement options*

VARYING THROUGH RETIREMENT GLIDEPATHS

Despite separating target date fund managers into two camps with respect to the glidepath, all "through" retirement managers are not created equal. Of importance to this discussion is the variation in glidepaths among firms that manage their target date funds through retirement.

We examined the post-retirement equity rolldown of the 25 firms identified in our universe that manage their strategies through retirement. Put simply, how many years does it take post-retirement before a target date fund reaches its final, static allocation?

For the 25 funds that are managed through retirement in our universe, six funds (24%) continue to roll down the glidepath zero to less than ten years post-retirement. Thirteen funds (52%) continue to roll down the glidepath ten to less than 20 years post-retirement and six funds (24%) continue to roll down the glidepath over 20 years post-retirement.

CONCLUSION

By 2015, target date funds are expected to capture $1.7 trillion worth of asset flows and account for 60% of all defined contribution assets and revenues[8]. Target date funds have soared in popularity since 2006 and while issues have emerged and further education is critical, the goal will be to enhance the industry as it evolves and grows.

Some argue that focusing on the "to" vs. "through" debate diverts attention from the real questions that should be asked when structuring a target date fund strategy. For example, J.P. Morgan studied the withdrawal patterns of participants over age 65 and found that of those who stopped working in 2006, 80% withdrew their entire account balances within the following three years[9]. Others argue that most funds are in fact managed through retirement since they expect participants to remain invested in the fund following retirement. A true "to" retirement option would require participant action at retirement, such as liquidation[10].

We believe the more appropriate dialogue for target date funds should be centered on the investment goals of the strategy and whether or not those goals are appropriate for client investment objectives. Therefore, we seek to clarify the distinction between funds managed to versus through retirement, but we are not advocating for one way of managing the glidepath as superior to another. Instead, our focus is on underlying plan participants and working with plan sponsors to determine which option is most appropriate for participants' needs.

[6] Morningstar Target-Date Series Research Paper: 2010 Industry Survey, August 17, 2010.

[7] Morningstar Target-Date Series Research Paper: 2010 Industry Survey, August 17, 2010.

[8] McKinsey & Company: Winning in the Defined Contribution Market of 2015

[9] Ready! Fire! Aim? J.P. Morgan Asset Management, 2009.

[10] DC Focus: Keep Your Eye on the Target. *Target-Date Funds: Getting Back on Point*, Betsy Massar, Fall 2010.

Jeri Savage is an Equity Research Associate at Evaluation Associates, LLC.

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