

# INSIDE TARGET DATE FUNDS

*With the proliferation of options available today, how can plan sponsors select the target date strategy that best fits participant needs?*

BY SUSAN CZOCHARA

**T**he U.S. Pension Protection Act of 2006 (PPA) has encouraged plan sponsors to take a closer look at their plans' investment offerings, specifically the default investment option. Guidance in the legislation indicates that target date funds, otherwise known as target maturity or lifecycle funds, are an appropriate default investment option for defined contribution plans. This has led to substantial growth in the number of target date solutions being offered.

Although most target date strategies look similar at first glance, there are certain key characteristics that differentiate products. Evaluating the asset allocation construction methodology, the management style of the underlying assets, and the type of investment vehicle being offered should help plan sponsors ensure they select the proper solution for their participants.

## Glidepath Dynamics

So how does one begin to evaluate a target date strategy? Since the foundation of target date funds is the asset allocation, or "glidepath," it's important to review the asset classes used in the fund and how the allocation strategy is constructed.

The asset mix should be globally diversified and include asset classes that provide inflationary hedge protection. Global diversification includes allocations to equity and fixed-income securities from the United States as well as from developed and emerging international markets. As many overseas markets have become more established and liquid, they now provide increased diversification benefits and the potential for higher returns. The inclusion of Treasury Inflation-Protected Securities (TIPS), commodities or real estate can provide additional diversification, as well as a hedge against inflation. A globally diversified, inflationary-hedging glidepath increases the potential to maximize returns and minimize volatility within the target date portfolio.

A review of the methodology behind the glidepath construction, including how the allocation decisions are made, is essential. Almost all target date funds use historical returns and correlation data as the foundation of the asset allocation process. However, a robust asset allocation process will also include forward-looking



capital market assumptions that are reviewed periodically to reflect current market conditions. A dynamic asset allocation process that has the flexibility to add or remove asset classes and to make slight adjustments over time has a much greater chance of success than a static model.

## The Active vs. Passive Debate

Typically, a plan sponsor's objective when selecting a target date solution is to identify a strategy that offers consistent performance through a risk-efficient, cost-effective strategy. Most target date funds are implemented using a fund-of-funds structure with either all actively or all passively managed component funds. However, hybrid, or blended, structures are becoming more popular because of their ability to offer greater risk/return efficiency at a lower fee.

The approach used in a fund-of-funds structure could impact the strategy’s ability to meet performance objectives. An all-active management structure has the potential for greater returns, but the associated fee structure and increased volatility might outweigh the potential for incremental performance. An all-passive management structure provides plan participants with exposure to multiple asset classes in an extremely cost-effective manner. This strategy provides no potential for incremental return, but that may be acceptable to some plan sponsors because of the low fees associated with such a structure.

A blended strategy — combining active and passive structures — provides the opportunity to capture the best of both approaches. For example, a passively managed fund can be combined with an enhanced strategy, whereby the enhanced approach generates additional return. Since both strategies are risk-controlled approaches, the combination reduces the overall volatility of the portfolio and provides an optimal risk/return tradeoff. Enhanced strategies also are more cost-effective than actively managed components, with fee structures that tend to be about half that of active strategies. Because of their potential to produce consistent returns in a risk- and cost-efficient manner, blended strategies are growing in popularity.

**Delivering the Solution**

The final consideration — and likely the most important factor for plan sponsors — is the type of investment vehicle that is being offered, primarily because this has a direct impact on the fees incurred when providing a target date solution.

Mutual funds have been the vehicle of choice for plan sponsors because they were the only funds valued on a daily basis. However, collective funds — specifically set up for ERISA



“Although most target date strategies look similar at first glance, there are certain key characteristics that differentiate products.”

– Susan Czochara, senior product manager at Northern Trust

qualified assets — are becoming an attractive alternative because they also offer daily valuation, have greater fee transparency and are priced, on average, much lower than mutual funds. In addition, collective funds’ fees often decrease as invested assets increase. Plan sponsors also can bundle fees across all defined benefit and defined contribution plan assets invested in the funds. This fee structure is far more attractive than the typically static expense ratios of mutual funds.

Separately managed target date strategies are even more flexible and can be customized for a plan sponsor. This option, however, is only available for very large plans where proper scale and diversification can be achieved. Overall, collective funds tend to be the best fit for most plans, given the flexibility and transparency of their fee structures.

**Conclusion**

By understanding the product nuances among target date offerings, plan sponsors can identify the most appropriate strategy for plan participants. Evaluation of a strategy’s asset allocation methodology, the management style of the underlying assets and the type of vehicle being offered will lead plan sponsors to the solution that best fits their fiduciary objectives. ♦

# Choosing the Best Possible Investment Vehicle

Careful consideration of the differences between investment vehicles helps defined contribution plan sponsors select the appropriate target date options for plan participants.

VEHICLE	ADVANTAGES	DISADVANTAGES
<b>Mutual Fund</b>	<ul style="list-style-type: none"> <li>Brand recognition in some cases</li> <li>Good fit for plans &lt; \$50 million in size</li> </ul>	<ul style="list-style-type: none"> <li>Lack of flexibility and transparency in fee structure</li> <li>Typically higher fee structure</li> </ul>
<b>Collective Fund</b>	<ul style="list-style-type: none"> <li>Typically lower fees, greater transparency</li> <li>Good fit for ALL plan sizes</li> <li>Use same trade and settlement process as mutual funds</li> </ul>	<ul style="list-style-type: none"> <li>Perceived lack of public information although information sharing via Internet becoming prevalent</li> </ul>
<b>Separate Account</b>	<ul style="list-style-type: none"> <li>Flexibility in fees</li> <li>Customization</li> </ul>	<ul style="list-style-type: none"> <li>Appropriate only for mega-sized defined contribution plans</li> <li>Do not use same trade and settlement process as mutual funds</li> </ul>

Source: Northern Trust