A New Target

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The full article may be accessed here.

Central Issue of the Paper

Target-date funds are the key to the future of retirement savings for American workers. While these funds have seen tremendous asset growth over the past decade, their investment design hasn't kept pace with available innovations. The result: many target-date strategies may fail to guard against today's heightened retirement risks. A white-paper titled "Designing the Future of Target-Date Funds" by Daniel Lowy and Christopher Nikolich from AB revisit target-date fund designs and single-manager structures to address this very problem. They indicate that most retirement plans still use traditional designs that were adopted years ago, but fiduciary standards have changed. In fact, the US Department of Labor (DOL) has issued "Target Date Retirement Funds: Tips for ERISA Plan Fiduciaries," which highlights the need for plan sponsors to have a solid process for selecting and monitoring their target-date choice.

The investment environment has changed, too. A broader range of strategies is now available and time-tested, beyond traditional equity and fixed income. These strategies can help reduce sensitivity to market, interest-rate and inflation risks at different points in the glide path. And diversifying against these risks can improve overall outcomes versus a traditional glide path roughly 80% of the time.

Approach Employed by Paper

Target-date funds have grown sharply over the past decade— more DC plans offer them, more participants use them, and asset totals reflect their popularity. During that same time, investing strategies and vehicles have continued to evolve. Target-date design has not kept pace, failing to reflect best practices adopted by other big pools of assets overseen by fiduciaries, such as pensions and endowments. Those best practices include:

- Using multiple investment managers to enhance diversification at several levels
- Independent fund selection
- Nontraditional investments, such as commodities, real estate and other liquid and illiquid alternatives
- Dynamic methods for muting the most damaging effects of extreme market volatility

Why has the target-date landscape been slow to innovate? One factor may be that the top three target-date fund providers account for roughly three-fourths of the assets in the market—due in large part to their strong, historically bundled recordkeeping operations. No other large asset pool has such heavy concentration among so few providers—not retail mutual funds, high-net-worth investors, defined benefit (DB) plans, sovereign funds or endowments.

Another, perhaps bigger, concern is glide path diversification. The glide paths of these dominant providers aren't well diversified, by today's standards. A hypothetical average blend of the three dominant glide paths is composed almost entirely of stock and bond portfolios, with some cash and other short-term instruments in participants' later years. There's a nod to nontraditional investments, but it's only a minimal sliver of real assets such as commodities and real estate. It's also mostly limited to real estate investment trusts (REITs)—perhaps the most traditional investment in the nontraditional arena.

In sharp contrast, the largest DC plans have taken note of institutional best practices and gravitated toward customizing their target-date funds, tailoring the asset allocation to participant demographics. But DC plan sponsors have found that customization provides bigger benefits: control over underlying managers and a more diverse mix of asset classes. That diverse mix often incorporates a range of alternatives and nontraditional investments to further diversify traditional stock/ bond allocations. For some investors, alternatives carry an undeserved stigma of outsize risk, but nontraditional investments (beyond simple stocks and bonds) are helpful in a comprehensive, long-horizon retirement investment. Nontraditional investments help reduce risk and generate return, which is important, given the more challenging return environment we have witnessed as of recent. Moreover, the enhanced use of diversifying asset classes has been highlighted as a key reason that both large endowments and state pension plans outperformed target-date funds.

We may see an acceleration in the gradual migration toward customized and multi-manager solutions in the next few years, partly due to the DOL's suggestion that fiduciaries look into custom or nonproprietary target-date funds (see "US Department of Labor: Focused on Target-Date Oversight," access the full article in the summary above). The DOL's recommendation is significant, given the heavy asset concentration among the major traditional target-date fund providers.

Findings of the Paper

Target-date assets are a critically large pool of assets, one that will only increase in importance for the future of many workers, many companies and the economic well-being of the country. But as the author's noted earlier, the target-date industry lags behind the rest of the investment-management world.

Traditional, first-generation target-date solutions still dominate DC plans. These solutions typically use single managers, traditional stock and bond asset classes, and allocations that tend to be static. Usually, these early solutions stick to entirely active or entirely passive investing approaches, rather than mixing the best of both for the different asset classes where active or passive makes the most sense. Traditional target-date funds also focus nearly exclusively on the accumulation phase of the glide path— lacking any thoughtful solution for what happens during the 30 or more years without a paycheck that many participants will encounter.

The authors believe that target-date providers and DC plan sponsors need to push toward multi-manager, open-architecture mandates that incorporate a broader collection of diversifying assets, that can dynamically adjust the glide path when market conditions change, that can take the best of active and passive approaches, and that embrace better solutions for the distribution phase—not just accumulation.