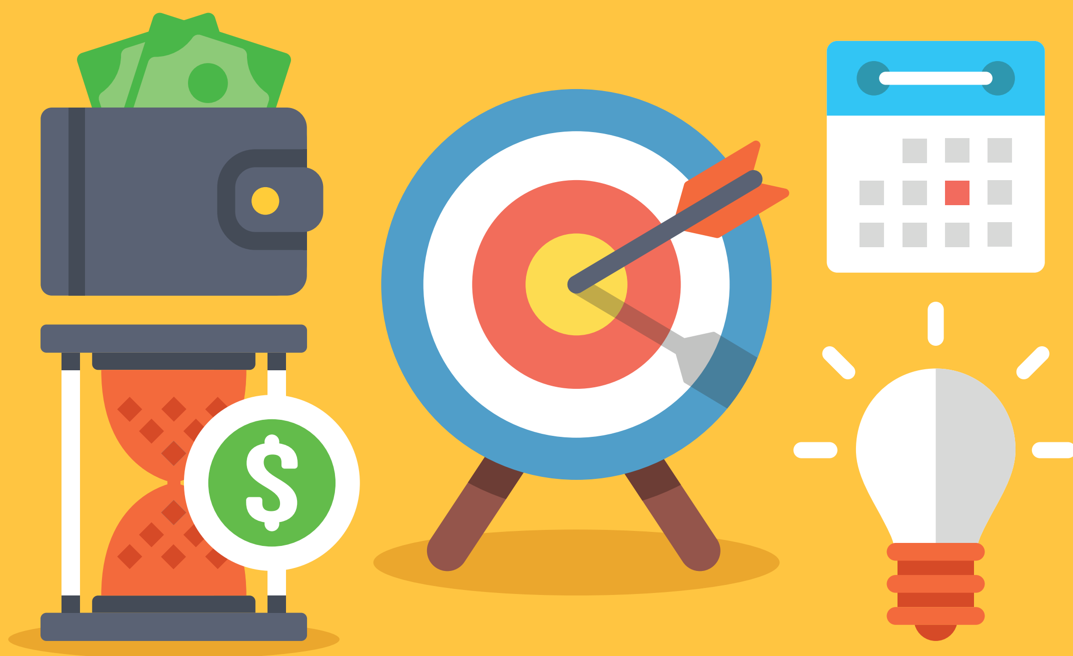
FEATURE



Target-Date Funds: The Next Generation

BY NEVIN E. ADAMS, JD

Target-date funds are helping a new generation of savers invest appropriately — but what will the next generation of TDFs bring to the fore?

It's been nearly a quarter century since the first target-date funds were introduced by Wells Fargo and Barclays Global Investors. Since then, much has changed, not the least of which is the ubiquitous positioning of TDFs on retirement plan menus, and their near monopoly as an investment default in those plans. The Employee Benefit Research Institute (EBRI) notes that nearly 65% of 401(k) plans, covering nearly three-quarters of 401(k) plan participants, included target-date funds in their investment lineup at year-end 2015. The Investment Company Institute notes that 88% of target-date mutual fund assets were held through DC plans (67% of the total) and IRAs (20%) at year-end 2016.

Those factors have not only fueled enormous growth in the category — assets in target-date portfolios expanded 20% in 2016, growing from $1.11 trillion at the end of 2015 to $1.33 trillion last year, according to Sway Research — but are laying a new investment foundation for a new generation of retirement plan savers. Consider that at year-end 2015, a full third (34%) of the account balances of recently hired participants were invested in target-date funds, according to EBRI. And that research firm Cerulli Associates estimates TDFs will capture roughly 90% of all new 401(k) contributions by 2020.

Despite that growth, change has been slow to come to the category, where roughly 80% of the total assets are still in the hands of four large proprietary recordkeeping providers. But change is afoot — and a new "next" generation of target-date funds has finally started to emerge from the crowd.

What are the trends that are shaping the next generation of target-date funds?

Broader Diversification with Nontraditional Asset Classes

One of the differentiating factors for some target-date funds has been the inclusion of alternative asset classes, such as hedge funds, commodities, real estate and high-yield bonds — asset classes that can provide diversification benefits to the portfolio as they have traditionally done for defined benefit plans.

Of course, these alternative classes generally bring with them higher costs and — depending on the perceived diversification benefits — that might serve as a bit of ballast on their growth potential.

Multi-Manager/Open-Architecture Format

Single-manager TDFs remain the norm, even among the largest plans, according to a survey by PLANSPONSOR. Indeed, mega plans (those with more than $1 billion in assets) are considerably more likely to have that structure in place than are smaller plans: 62.6% of mega plans do, compared with just 29.6% of micro plans. On the other hand, nearly a quarter (23.4%) of those micro plans say they don't use a target-date fund for their qualified default investment alternative (QDIA).

Those pitching non-proprietary options

have long — and with justification — noted that no firm can be the best at managing every asset class, though the convenience of proprietary solutions doubtless muted some of those voices. However, in 2013, the Labor Department suggested plan fiduciaries revisit their target-date fund selection and specifically recommended that they consider non-proprietary target-date funds. That message too may have been slow to take hold, but litigation concerns and a renewed emphasis on fees may be turning that tide. Certainly those offerings are already available in the marketplace.

Little wonder that nearly half (46%) of financial advisors managing at least $50 million in DC assets continue to advocate using an external manager for target date funds rather than the proprietary TDFs offered by the current plan recordkeeper, according to Cerulli.

A Push for Passive

Spooked by litigation, and in some cases simply more conscious of their fiduciary obligations, plan fiduciaries are evermore fee-sensitive, and trends that have emerged in investment menus overall have found their way into target-date fund infrastructure. For example, assets in collective investment trust (CIT)-based target-date portfolios rose from $355 billion at the end of 2015 to $458 billion in 2016. Shay Research notes that the 29% growth rate was nearly twice the pace of growth in mutual fund target-date assets, which swelled from $760 billion to $878 billion year-over-year — a nothing-to-sneeze-at growth rate of 16%.

...and More CITs

Similarly, utilization of passive strategies in target-date funds has also surged. Indeed, the passive-CIT combination has proven to be particularly attractive; target-date assets in passively managed mutual fund and collective investment trust (CIT)-based target-date portfolios totaled $653 billion at the end of 2016, well ahead of actively managed portfolios, which held $594 billion and had a billion-dollar edge at the end of 2015 ($524 billion to $523 billion), according to Sway Research's report, "The State of the Target-Date Market: 2017, Examining Asset Trends Across Providers, Products, Vehicles, Management Styles, and Key Features." At the end of 2016, just 38% of target-date fund mutual fund assets were in passively managed products (60% was active, and 2% was hybrid), but 69% of assets in CIT-based target-date series were in passively managed series (16% was hybrid and only 15% was active).

"Offering a target-date series in a CIT format is must today", explains Chris Brown, Principal & Founder of Sway Research LLC. Moreover, he says that having other portfolios in a CIT format or non-revenue sharing mutual funds) is "imperative" for investment-only managers looking to plug into custom model-driven TDF solutions. "The bigger the plan the more important fees become, and the more prevalent passive management becomes," he explains.

'Smart' QDIAs

These solutions — which change from target-date funds to managed accounts upon a trigger, such as a certain age, account balance, or other factors — could help build a pipeline for managed accounts. Worst case, it could be a new marketing pitch.

Embracing a Dynamic Approach to Portfolio Management

Despite the long-term focus of these portfolios, there are times where specific short term shifts can allow managers to better respond to market conditions, and a growing number are turning to dynamic asset allocation. After all, managing a target-date portfolio for a diverse group of participants — of widely varying age brackets — requires balancing multiple risks, including longevity risk. For example, it's a strategy that proponents say allows increasing equity exposure for younger savers when market environments are favorable for stocks, and can be used to pull back on market risk for participants closer to retirement when the markets have turned.

Taking Decumulation into Account

Way back in 2014, the federal government blessed guidelines that allowed target-date funds in 401(k) plans to invest in immediate or deferred fixed annuities. That included not only stating that that change in structure would still qualify as a QDIA. Even ahead of that, some providers of off-the-shelf target-date funds already offered versions with guaranteed income streams, where a portion of the underlying assets is invested in a sleeve that contains an annuity payout. Another approach, particularly in light of the guidance involves connecting the target date fund to a qualified longevity annuity contract (QLAC) that can provide a longevity "safety net."

These cushions don't come without some cost, however — and in an era where fees are drawing a lot of attention, the reasonableness of that tradeoff would have to be considered.

Shift to 'Single Fee' vs. 'Acquired Fee'

Some providers have already switched from basing the expenses of their target-date funds on the expenses in the underlying portfolios (i.e., acquired fee), to a single-fee model, which is not affected by the underlying investments. "This provides more flexibility in the underlying portfolios, which should prove to be a marketing advantage, Brown explains, "and, if all goes well, a performance advantage too."

Dynamic QDIAs

Rather than merely relying on participant age (or, more precisely, anticipated retirement date), these QDIAs use information such as marital status, additional assets, DB plans, plan balance, etc. to create a more customized asset allocation. This so-called "dynamic" QDIA works much like a managed account — indeed, some dynamic QDIAs essentially are managed account products bolted onto target-date funds.

Of course, garnering the information required to provide that level of customization can be problematic.

What's Next?

Most of these next generation solutions can be found today, of course, though it can be harder to find some than others. And, if the dominance of a few major players in the target-date fund space seems unlikely to dissipate quickly, there are portents that must nonetheless be considered by all — a heightened focus on fees, a preference for passive alternatives (likely inspired by that focus on fees), and a general desire for prudent alternatives that bring with them a minimum amount of administrative hassle.