# GROWTH AND EVOLUTION

**Retirement plan sponsors continue to favor target-date funds as a default option, for good reason. As auto-enrollment and auto-escalation boost individual retirement accounts, target-date funds do the asset allocation and rebalancing to ensure well-funded retirements.**

Target-date mutual funds continue their multi-year trend of strong growth, with assets reaching an all-time high of $880 billion at the end of 2016. More providers offer them, as well: While three top managers continue to hold the lion's share of target-date assets, at the end of 2016, 12 firms offered more than one target-date series, catering to a variety of clients, whereas ten years ago, no firm offered more than one, according to Morningstar.

In addition to their growth and proliferation, target-date funds have evolved in response to investor preferences and an increased focus on longevity. "When the first target-date funds came onto the market in the early 2000s, the general view was to focus solely on what happens at retirement," says Wyatt Lee, portfolio manager, target-date solutions at T. Rowe Price. The idea was to invest in a defined-contribution (DC) plan for a period of time to build a pool of assets; at retirement, the wealth accumulation game was over, and it was time to be defensive by preserving wealth. "Now, many DC plans recognize that people's savings require reasonable growth to support a potential 30-year income stream in retirement," he says.

The key evolution of such plans is to provide the investment growth needed to fund today's longer retirements. "Target-date funds have been evolving in terms of investable asset classes, capital market expectations, and demographic shifts, including increased longevity," says Nick Nefouse, head of the DC investment and product strategy team at BlackRock. "We have done a lot of research into income patterns and spending preferences," he adds.

# Taking an Objective View of Glide-Path Design

Glide-path design happens at the intersection of financial and behavioral economics. This is because retirement outcomes depend not only on investment returns, but also on the cash flow (i.e., the saving and spending) behavior of the investor.

T. Rowe Price's glide-path framework is intended to flexibly accommodate a broad range of plan characteristics and preferences. Our approach embraces the principle of economic utility, a term that refers to the level of satisfaction or dissatisfaction derived from a good or service—an asset-allocation glide path in this case. The primary goal is to find the glide path that maximizes utility satisfaction as defined by investor preferences and constraints. Because retirement outcomes are uncertain, this level of satisfaction must be judged in terms of the probability of potential outcomes. In this sense, we view glide-path design as a classic example of outcome-oriented investing.

We also seek to ensure the design is robust in satisfying the heterogeneous nature of participant demographics and risk preferences. Thus, our framework incorporates a set of customizable preference parameters to account for attitudes toward risk, consumption, longevity, etc.

**Setting Objectives**

Our research focuses on the primary investment objectives of target-date investors:

- **Consumption:** the objective to fund an adequate and sustainable level of consumption after retirement.
- **Balance Stability:** the objective to promote the stability of retirement account balances by limiting the volatility of portfolio returns.

These objectives are at odds in that higher levels of equity assets aid the Consumption objective due to higher expected returns over the long run, but higher levels of equity assets also detract from the Balance Stability objective due to higher expected volatility.

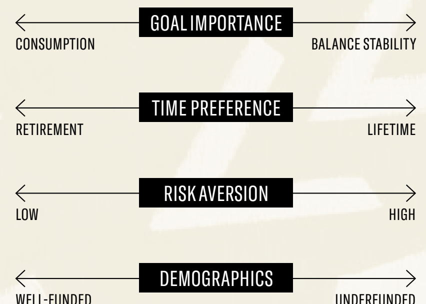
While both objectives are undoubtedly important, each plan sponsor may weigh their relative importance differently.

**Factors That Influence Glide-Path Design**

The relative emphasis placed on the two objectives of Consumption and Balance Stability is a key driver of glide-path design, but other variables should be considered:

- **Time preference:** the degree of focus on outcomes at the retirement date versus the focus on outcomes at all periods equally.
- **Risk preference:** the degree of risk aversion with respect to achieving each objective.
- **Demographics:** earning levels, savings rates, Social Security/state pension income, retirement age, life expectancy, etc.

Because the behaviors and attitudes of retirement plan participants vary widely, it is critical that the resulting solution does not unfairly favor some segments of the participant population over others. For this reason, our approach emphasizes that the solution must be robust in satisfying the heterogeneous situations and preferences of various segments of the participant population. ●

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Furthermore, the complexity of target-date portfolios has evolved. Originally, non-U.S. exposure was simply to developed markets, which subsequently expanded to include emerging markets and international small-cap. "It's been an iterative process of widening out the opportunity set to provide the best risk-adjusted returns," says David Ireland, global head of defined contribution at State Street Global Advisors. Inflation-hedging assets are now part of the mix. "They're really important, especially when heading into retirement, when retirees need to maintain their purchasing power," he says. "Inflation is a looming risk, and overall, the DC industry is underexposed to inflation-protected asset classes."

Target-date fund (TDF) offerings have become more diversified, as well. "Early on, the underlying target-date strategies were pretty vanilla," says Lee, with mostly large-cap U.S. stocks on the equity side and investment-grade U.S. bonds on the fixed-income side. As the market became more comfortable with the TDF concept, portfolio managers had a greater degree of freedom, with more diverse strategies being implemented. On the equity side, target-date funds invest across a range of capitalizations and styles; they are more global; and they include inflation-sensitive instruments. On the fixed-income side, they invest globally; include high-yield; and use more specialized strategies to manage duration risk. "We continuously evaluate each element of the portfolio and deploy more sophisticated and precise levers to respond to market conditions," Lee says.

The art of the target-date fund is understanding how to blend financial assets or savings with a participant's ability to work, and to adjust the weighting over time. Implementing that appropriate glide path is critical. "Using the wrong glide path means that participants will either need to save more or take unnecessary risk over their lifetimes to get to a similar outcome," says Nefouse. The aggregate amount of risk taken across the glide path is ultimately what drives outcomes. "At which point in time the glide path takes risk is as important as the amount of risk it takes," he says. "Without a glide path, we have merely a balanced fund." The glide path inputs explicitly connect the fund to an individual's income, and how that income changes over a lifetime.

Early versions, first introduced 20 years ago, were launched with ten-year age bands, but now they're available in five-year increments that participants can correlate more easily to their retirement dates. Another key difference is the evolution of the glide path: Now there are a range of glide-path options, and plan sponsors can choose which one best meets the needs of their plan participants. For example, some funds are focused primarily on providing lifetime income, and others are focused on protecting assets around the time of retirement. "We've seen these different objectives grow and evolve in the market over time," says Lee.

While target-date funds are designed to be a participant's sole menu option, many participants use them in combination with other investment vehicles. "The glide path is designed in a specific way, based on capital-market expectations, longevity assumptions at a given age, and expectations for future income," says Nefouse. Target-date funds are complex instruments calibrated to provide a reasonable range of expected outcomes. However, "Using them in combination with other investment options can radically alter a participant's risk profile in ways that most non-professional investors may not be able to anticipate," Nefouse says.

**Improving Savings Rates**

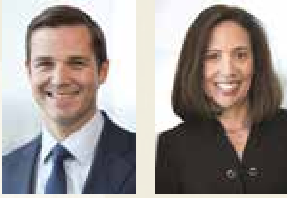
Adequate savings rates are a prolonged challenge for American workers. "The average retirement account for a 55- to 65-year-old is only about $104,000," says Ireland, of those households with access to employee-sponsored retirement plans. Furthermore, prolonged periods of low interest rates have led to lower long-term return expectations across traditional asset classes, and younger generations will have to save a larger share of their income to generate the same level of retirement readiness as their older counterparts. "Target-date funds do a great job of moving people through the wealth-accumulation savings years," he says. TDFs are designed to provide a diversified portfolio of traditional assets with age-appropriate levels of risk. Asset allocations are rebalanced from mainly growth assets to mainly income assets, following a glide path over a long-term horizon.

However, at retirement, many individuals who rely on their DC investments as their primary source of savings are challenged with translating that accumulated wealth into a steady income stream. "The onus is on the participant to figure out what that asset base will support in terms of monthly or annual post-retirement income, and how to convert that asset base into that steady income," says Melissa Kahn, managing director of retirement policy strategy at State Street Global Advisors. "We call it the 'wealth illusion.'"

Many see a pot of money — more than they've seen in their lifetime — when they have been used to receiving a regular paycheck. Translating the principal into sustainable income can be challenging. "They'll either overspend or underspend as a result, because they have no idea of their mortality," Kahn says. It can be challenging to manage this process effectively, and the industry is working with legislators and regulators to address this issue. One initiative, now in Congress, would mandate a lifetime income disclosure statement to indicate how a current retirement account balance translates into monthly income. "It's a real wake-up call when plan participants see that their $100,000 savings at age 65 would translate into only $400 a month," says Kahn. "It's an astounding point of reference for most people."

The art of the target-date fund is understanding how to blend financial assets or savings with a participant's ability to work, and to adjust the weighting over time. Implementing the appropriate glide path is critical.

# Working to Improve Retirement Savings



***With a broad suite of target-date funds and a depth of other investment products and expertise, State Street Global Advisors works in-house and with policy makers to improve retirees' financial outcomes. David Ireland, global head of defined contribution, and Melissa Kahn, managing director of retirement policy strategy, explain how.***

**How does SSGA approach customization of target-date funds?**
**Ireland:** Target-date funds are designed using certain assumptions around the participant population, but they can be customized to accommodate a plan sponsor's preferences, like unique employee demographic characteristics, such as an early retirement age, or varying compensation arrangements, such as a defined benefit plan or ESOP. For example, one particular plan sought a strategy that de-risked more quickly than usual. We worked with them to shift the glide path five years earlier. Also, a plan sponsor may prefer open architecture to select its own investment managers. In these cases, we establish the glide path and manage the overall arrangement.

**How do target-date funds address low savings rates and other behavioral issues?**
**Kahn:** The first step is to make sure employees are in the plan, and auto-enrollment is an effective method to ensure this. Plan sponsors also help participants make better investment choices through appropriate QDIAs, which is usually a target-date fund. However, it is crucial that employees make sufficiently high contributions, and while default percentages remain low, the increased use of auto-escalation is helping to increase contribution rates without requiring active decisions. Research shows that participants will accept higher default contribution levels without opting out, and we believe plan sponsors should consider raising them.

**How else is SSGA improving retirement savings and income?**
**Ireland:** The prudent drawing down of assets in retirement is a major challenge. We are launching a next-generation target-date fund with an embedded advanced life annuity component. This will provide plan participants with the benefits of low-cost, broad diversification in the wealth accumulation years, and management of post-retirement drawdown with true longevity management in later years.

**What other initiatives are you working on with legislators and regulators?**
**Kahn:** The looming retirement funding shortfall is gaining more attention from policy makers, and many states have started to address retirement issues, but we need something on a federal basis. We're working closely with members of Congress to discuss our various proposals, which include requiring all employers to auto-enroll their employees into a DC plan and auto-escalate their deferral rates. Our proposal ensures that small employers are not burdened by this requirement by providing tax credits and removing impediments to establishing collective plans sponsored by consortia of smaller companies. Taken together, our proposals are designed to help to ensure that all workers have a secure retirement. ●

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SSGA Target Date Funds are designed for investors expecting to retire around the year indicated in each fund's name. When choosing a Fund, investors should consider whether they anticipate retiring significantly earlier or later than age 65 even if such investors retire on or near a fund's approximate target date. There may be other considerations relevant to fund selection and investors should select the fund that best meets their individual circumstances and investment goals. The funds' asset allocation strategy becomes increasingly conservative as it approaches the target date and beyond. The investment risks of each Fund change over time as its asset allocation changes.

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* Assets under management were $2.56 trillion as of March 31, 2017. AUM reflects approx. $33.33 billion (as of March 31, 2017) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; State Street Global Advisors Funds Distributors, LLC and State Street Global Advisors are affiliated.

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The well-known strategies of auto-enrollment, auto-escalation, and reenrollment remain essential to help boost participant savings, but even when considering innovations in DC, there continues to be an effort to get the most out of the available tools. "BlackRock is leveraging technology at the plan level and in participant engagement to help drive decisions," says Nefouse. With that in mind, sponsors can drive appropriate changes to boost savings rates, improve diversification, and build retirement income potential. "With participants, we incorporate communication techniques from outside our industry, such as interactive video, that enable participants to get targeted messaging that helps them take appropriate next steps for their situation," he says. These tech-enabled approaches to communications allow for increased personalization, while remaining simple for the sponsor to implement.

"There are other ways that DC providers can help and encourage plan participants," says Nefouse. One is to attempt to cushion volatility for participants near retirement so they don't pull out of the market at the wrong time — after a loss. Providers can also try to shift participants' attention away from the current dollar value of their account toward a focus on how to achieve sustainable retirement spending targets. In addition, participants can be encouraged to focus attention on what they can control, such as how much they save and their retirement planning, and less on the day-to-day market.

Savings habits vary among generations. "Gen-X and boomers aren't as accustomed to auto-enrollment and other auto features that have evolved, versus millennials, who have been opted in, and they tend not to opt out," says Lorie Latham, senior defined contribution strategist at T. Rowe Price. Millennials tend to stay in DC plans, although often just at the default rates, which remain low, and in the default options, which are target-date funds. "Longevity is one of the key components that target-date funds should solve for," Latham says. Longevity isn't necessarily on the minds of millennials, but TRP's target-date solutions are designed to address longevity by maintaining opportunity for growth into retirement.

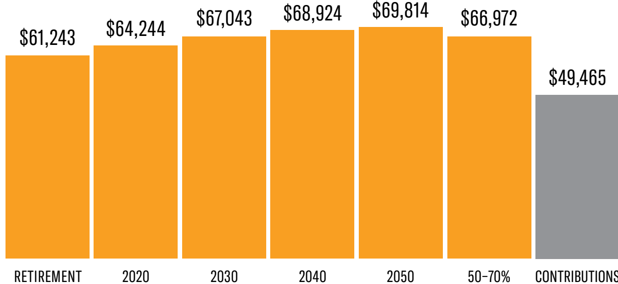
Target-date funds' growth and popularity are largely due to their role as the default investment option in most DC plans, as the benefits of target-date funds address many of the issues that face DC plan participants. "Pre-retirees and retirees both are developing a greater awareness of longevity," says Latham. Pre-retirees need to manage the planning process—how best to save, build wealth, and decide what will be enough to retire on—while retirees must focus on how to generate income. "Both groups wonder if their lives will outlast their money," she says.

Auto-enrollment and default options aside, target-date funds present a strong value proposition. "Participants value the broad diversification, automatic rebalancing, and programmed de-risking elements," says Ireland. Furthermore, fees have come down quite a bit across target-date funds as they become a larger percentage of plan assets. "A big portion of the inflows can be attributed to the fact that target-date strategies are deemed to be the optimal solution for the majority of DC investors, which is why they're typically the default," he says.

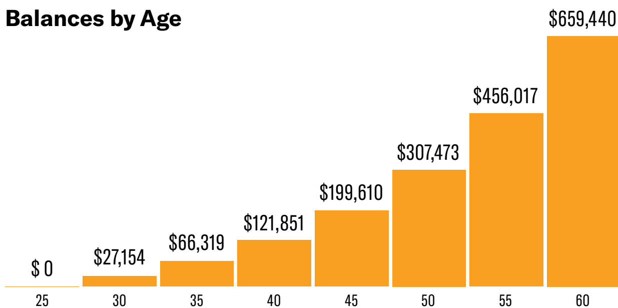
Indeed, target-date funds provide plan participants with access to a sophisticated, diversified product for a single fee. Beyond fees, there is also a cost associated with a participant's time. "BlackRock is very much aware of the fact that the more time an investor spends worrying about asset allocation, rebalancing, and other complex portfolio management problems, the less time that investor has to be a mother, a father, a sibling, or a friend," says Nefouse.

With the race to the bottom with respect to fees over the last decade or so, especially among passive funds, looking primarily at fees is the wrong way to select a target-date fund provider. Such decisions are better made on a holistic basis that considers many factors, as retirement outcomes are fundamentally determined by all the elements of product design. "The performance of a well-designed target-date fund that captures more upside, avoids more downside, and delivers the risk-return ratio that it seeks to achieve will, in the end, be a greater deciding factor," Nefouse says. ●

**Simulated Ending Balance From Ten Years of Savings and Contributions in Selected Target-Date and Allocation Categories**




**Simulated Account Balances by Age**




Source: Morningstar

# How the Target Date Fund Can Help Maximize Plan Design

Plan sponsors have two powerful tools that could help nudge participants toward improved retirements: plan design and target-date funds. However, these tools are frequently considered separately.

Plan design is used to encourage savings, often without analysis of the final balance that may be generated or its adequacy as a source of retirement income. Meanwhile, the target-date fund is selected based on a comparison of performance, fees, and risk.

Fully understanding the target-date fund's design, however, may help plan sponsors optimize the accumulation potential embedded in it. This can inform plan design choices, leading to potentially more effective deferral rates and — critically — a better understanding of the risk/reward tradeoffs between market risks and increased savings.

Depending on the fund, target-date funds may incorporate inputs that reflect real-world spending and income data, as well as tools to anticipate spending behaviors over a participant's entire working career. Plan sponsors can use this insight to help increase market exposure when savings rates and balances are likely to be low, and encourage increased saving as balances grow, earnings increase, and risk aversion becomes a greater factor.

**Understanding Participant Evolution**

Let's consider a typical participant at two stages of her career and the tradeoff between savings and investment risk:

**Participant at age 25:** Her savings balance is small and, given the realities of starting salaries and the financial pressure of student loans and other expenses, maximizing her deferral rate may not be a realistic option. That leaves maximizing growth potential on the table as an option.

A young participant may be uncertain in the face of market volatility, leading some plan sponsors to consider a lower equity exposure. We believe, however, that growth assets should be maximized when participants

have a lifetime of future earnings ahead of them. Based on our analysis, reducing equity exposure from 99% to 90% may not, over the course of a 40-year career, be significant enough to justify the potential of increased return. (Based on our analysis[1], the difference in annualized risk is estimated as 14.08% against 12.81% for the reduced equity portfolio.)

Armed with this understanding, a plan sponsor may decide that maximizing risk exposure early can help set a foundation for future savings — and ultimately retirement spending.

**Participant at age 45:** Our participant has begun to build a significant balance — and her aversion to market losses and volatility has likely increased. Ideally, two behavioral considerations may be reflected in the glide path. The glide path should begin to de-risk, leaving equity exposure high but layering in fixed income securities and, possibly, real assets or inflation protection, to soften the edge of volatility. (De-risking for most glide paths will begin to accelerate ten to 15 years before retirement.) But implicit in the glide path is the assumption that our participant is now entering her peak earning years. The increased flow into her portfolio if she maximizes her savings may help offset decreased growth potential, helping keep her on track toward her retirement goals.

**Knowing when to take risk**

In a recent BlackRock survey, 74%[2] of participants agreed that the purpose of retirement savings is to maintain current spending in retirement. In seeking to achieve this goal, when a participant should take risk is as important as the amount of risk they take.

BlackRock can work with plan sponsors using sophisticated Aladdin® risk analytics to help assess current plan design and investment options and recommend adjustments to help improve retirement readiness. We can also help plan sponsors understand and apply our empirically grounded, deeply researched target date glide path to optimize the balance between plan design and risk. ●

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Sources: [1] Morningstar Direct as of December 31, 2016. For illustrative purposes only. Based on comparison of four simple portfolios comprised of the S&P 500 Index and the Bloomberg Barclays U.S. Aggregate Bond Index. 99%, 90%, 40%, and 55% refer to the equity allocation in each simple portfolio. Analysis uses monthly historical returns of each index over the past 25 years. Assumes monthly rebalancing. Past performance is not indicative of future results. One cannot invest directly in an index.

[2] BlackRock 2016 DC Pulse Survey

**Investing involves risk, including possible loss of principal.** The target date in the name of the fund is the approximate date when investors plan to start withdrawing their money. Asset allocation and diversification strategies do not promise any level of performance or guarantee against loss of principal at any time, including at the target date. This material is not an offer to sell, nor an invitation to apply for any particular product or service.

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