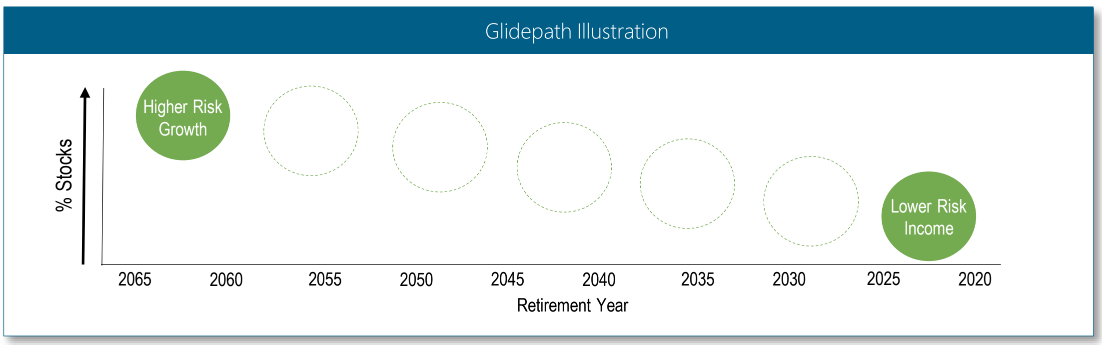
July 2020

One Size Does Not Fit All

The Differences Among Target Date Fund Series

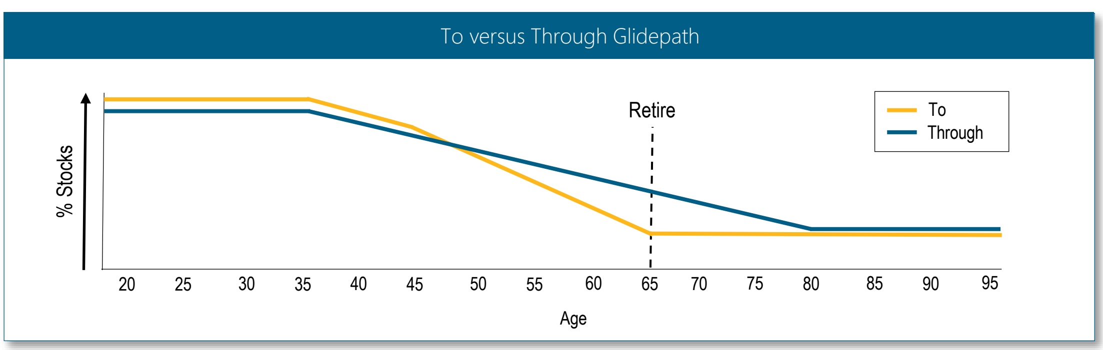
By Austin Ort, Managing Director

Target date funds (TDF) are investment options that incorporate a mix of stocks (domestic and foreign), bonds and cash that are managed to a specific retirement goal that an individual selects based on their expected year of retirement. A TDF *series* represents multiple individual target date funds with varying retirement dates (usually in 5-year increments) offered by a single investment company. An investor selects the fund that corresponds to their expected retirement date and their assets are automatically diversified among stocks, bonds and cash in a manner that is consistent with the recommended risk level for someone with the expected retirement date chosen. For younger investors that are further away from retirement, the fund will be positioned more aggressively for growth with a higher weighting to stocks. For investors closer to retirement, the fund will be positioned more conservatively with a higher weighting to bonds and cash. The process for systematically reducing risk (i.e. allocation to stocks) over time as the investor nears retirement is referred to as the fund's "glidepath" and it occurs automatically.



The Decision of "To" or "Through"

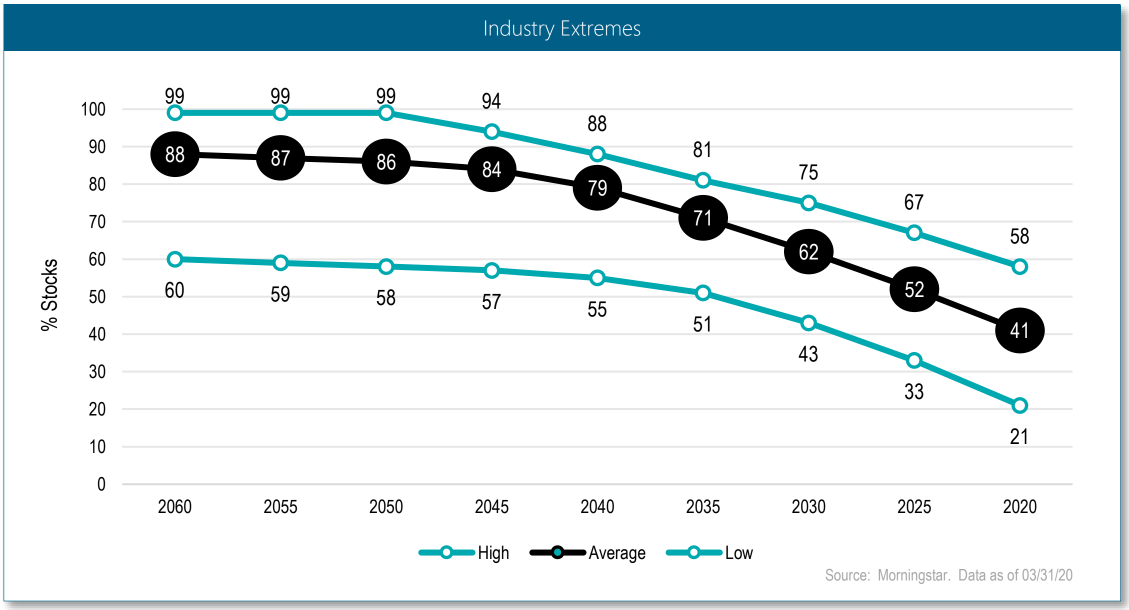
Each TDF glidepath represents a pre-defined schedule for reducing risk of the fund over time. Most TDF due diligence begins with the distinction between the "To" or "Through" methodology for reducing risk over time. Under the "To" approach, the TDF reaches its most conservative stock allocation at retirement. "Through" funds, on the other hand, generally maintain a higher stock weighting at retirement and continue reducing risk during retirement.



The age at which "Through" funds reach their most conservative stock allocation varies widely among TDF series which can lead to significant differences in investor risk exposure at and during retirement. Because of these differences, it is important for investors to fully understand a TDF series glidepath and when applicable, consider employee demographics, investment sophistication, and asset levels in the selection of a suitable TDF series.

Glidepath Allocations and Variance

The glidepath of a TDF series can vary by a significant margin as indicated in the following illustration which represents the extremes (upper & lower) and average stock weighting percentages of all industry TDF series at various retirement years.



In our view, an allocation of 75% in stocks (2030 TDF) when the potential retirement date is 10 years away can be viewed as an aggressive allocation. Conversely, an allocation of 60% in stocks (2060 TDF) when retirement is 40 years away can be viewed as a conservative allocation. One size does not fit all and the variety of TDF series gives an investor significant variability to select the best fit.

Portfolio Attributes

The other critical components in evaluating a TDF series are the glidepath lifespan, management style (active vs. passive) and the use of strategic or tactical allocation in the portfolios.

The glidepath lifespan defines the age at which the TDF will reach its most conservative point. This can vary from age 70 to age 95 depending on the TDF series selected. In other words, a fund that is managed until age 70 will reach its most conservative allocation when the investor is five years beyond the anticipated retirement age of 65. While a fund that is managed until age 95 will not reach the most conservative point until 30 years after an individuals' retirement.

Management style has an impact on the TDF fund selection as there are choices between active and passively (index) managed TDF series. An actively-managed fund will utilize a variety of actively managed mutual funds that make up the TDF to achieve the diversification requirements between stocks, bonds and cash. These funds will have a fund expense ratio that will fall between 0.31% and 0.52%, on average, for the largest fund families in the industry. Passively-managed TDF series will utilize index mutual funds as the underlying investments to achieve its diversification requirements. These funds will have expense ratios that will on average fall between 0.09% and 0.15%.

Lastly, it is important to consider how the TDF series is structured regarding its strategic or tactical allocations. A strategic allocation will set the glidepath and stick to it regardless of the market conditions. While a tactical allocation allows the portfolio manager(s) the ability to make tactical (active) adjustments to the stock, bond and cash allocations as market conditions change. The tactical allocations are utilized in most actively managed TDF series and allow the manager to increase or decrease the various stock, bond and cash allocations, generally up to 5% or 10% in either direction based on perceived market conditions.

Final Thoughts

In our analysis, there are many excellent options among the various TDF industry offerings depending on the objectives of the fiduciary or investor. Looking at TDF holistically and examining the structure as outlined above is the key to finding the most appropriate option. There should not be one factor that is the focus of the decision-making process as there are multiple variables to consider in selecting a TDF series that will best meet an investor's needs.