Target Date Model Portfolios

A twist on the target-date fund approach.

By Ron Surz and Jack Towarnicky

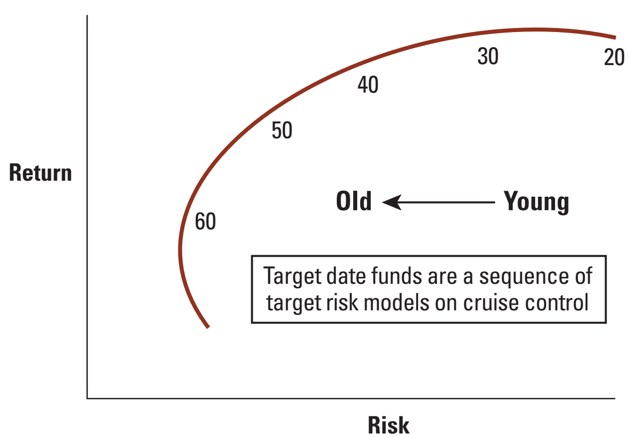
Target Date Funds (TDFs) are the fastest growing investment in individual account retirement savings plans because they are the most popular Qualified Default Investment Alternative (QDIA).[1]

But the use of TDFs as the QDIA is still in its infancy, having effectively been launched with the passage of the Pension Protection Act of 2006 and subsequent Department of Labor regulations.[2] So there is opportunity for innovations and improvements. Here, we offer one such innovation, target date models (TDMs).

TDFs can be viewed as a sequence of target risk models on cruise control, as shown in Exhibit 1. The typical TDF is a mutual fund or fund of funds, or a collective investment trust (CIT) incorporating a collection of target risk model portfolios and a glide path that will be followed as participants age, moving investment allocations from high risk to low.

TDMs are a set of electronic investment instructions that specify both the collection of risk portfolios and the glide paths. Where the TDM is deployed as a QDIA, a default glide path is created and deployed for each TDM. The plan's investment fiduciary can also adopt additional TDMs with other glide paths — so participants can move between TDMs with different glide paths should their situation change. Here the record keeper treats each TDM exactly as if the participant had made an affirmative investment election to allocate account assets across the core investment options used in the model.

Exhibit 1: Return vs. Risk



The TDM offers:

- **Transparency:** Because the TDM only uses an allocation across core investment options, the TDM is fully transparent to participants — they see the actual allocations whenever examining their account balance, and, they are notified whenever the model is rebalanced as the participant approaches the target date. Since all holdings in the TDM are in the core investments, details on

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[1] Investment Company Institute, 2018 Investment Company Fact Book, "…At year-end 2015, 65% of 401(k) plans offered target date funds, and 74% of 401(k) plan participants were offered target date funds. Participant use of target date funds also has increased and 50% of 401(k) plan participants in 2015 held these funds — up from less than 20% in 2006." Accessed 10/15/18 at: https://www.ici.org/pdf/2018_factbook.pdf See also: K. Pender, Target date funds surge as more workers put 401(k) plans on autopilot, San Francisco Chronicle, 6/5/18, Accessed 9/17/18 at: https://www.sfchronicle.com/business/networth/article/Target-date-funds-surge-as-more-workers-put-12969923.php See also: J. Holt, Morningstar, 2018 Target-Date Fund Landscape, 5/7/18. Exhibit 11. Accessed 9/17/18 at: https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/TDF_Landscape_2018.pdf?cid=EMQ_

[2] Pension Protection Act of 2006 (Pub. L. 109–280), 8/17/06; Department of Labor, 29 CFR §2550.404c-5 - Fiduciary relief for investments in qualified default investment alternatives, 73 FR 23350, 4/30/08.

investment strategy and performance are readily available.

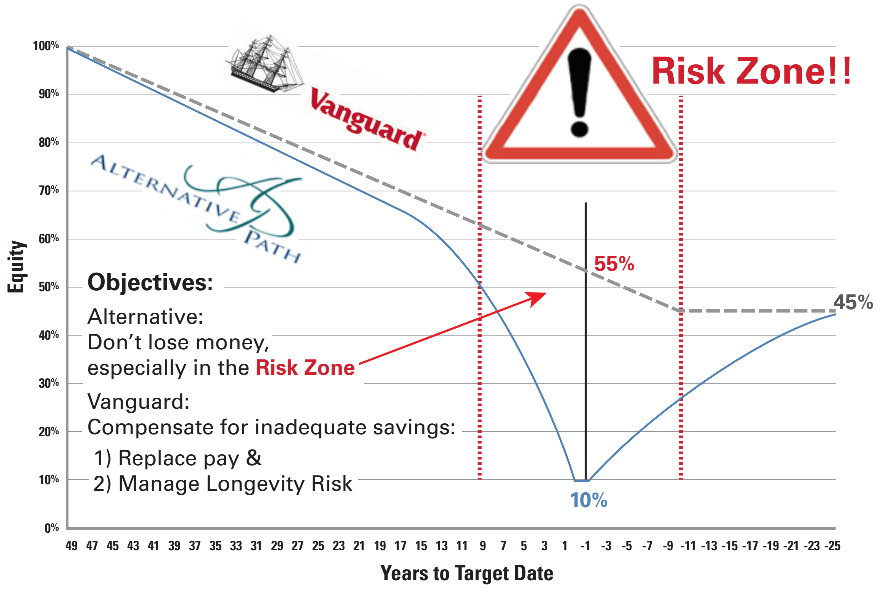
- **Tailoring:** As a QDIA, the TDM matches individual participant demographics. Non-defaulting participants can choose from a family of TDMs, including but not limited to the default.
- **Lower Ongoing Expenses:** TDMs can be significantly less expensive to operate because they do not incur trustee, audit and legal costs associated with TDFs.
- **Reduced Start-up Costs:** Periodic rebalancing across the core investment options avoids start-up costs including unitization.
- **Open Architecture:** TDMs need not limit investments to a single fund family.
- **Prudence:** Improvements for participants are also improvements for plan sponsors — leveraging the investment fiduciary's prudent selection of core investment options, lowering expense, etc.
- **Improved Participant Education:** Plan sponsors can educate participants on the logic and benefits of TDMs — whether the TDM applies as the QDIA default or was actively selected by a participant.

Model construction requires a knowledgeable and experienced designer of risk portfolios and glide paths. The designer may or may not also be a plan fiduciary.

Model Building

In a TDM, the risk models are built exclusively from core investment options selected by the plan's investment fiduciary — investment options already offered by the individual account retirement savings plan. TDMs leverage this structure — including

Exhibit 2: Equity Glide Path Choices



periodic review of performance and fees as well as adherence to investment strategy and guidelines such as an investment policy statement.

The model builder determines the allocations to core investment options for a given level of risk, i.e., age. While the investment performance of the core investment options matters a great deal, asset allocation may matter more — making the glide path critical.

Because the TDM leverages existing core investment options, complexity is reduced by avoiding the need to add 10 or more additional investment options (one for each target date). Fewer options may create the potential for economies of scale by concentrating assets in the existing core options — potentially lowering investment management fees.

Glide Path

The glide path refers to the equity allocation in the TDF or TDM. Two mileposts differentiate the relative risk among TDFs and TDMs — the equity allocation as of the target date and the landing point (where the minimum equity allocation at or after retirement is reached).

All TDFs generally use age 65 as the target date — the date when payouts from the individual account retirement savings plan are expected to commence. However, there are noticeable differences among equity holdings at age 65 — Vanguard at 49%, T. Rowe Price at 55%, Fidelity at 55%. Also, many TDFs use a "through" retirement glide path where equity allocations don't reach their minimum until long after the target date — Vanguard at age 75, Fidelity at age 80, T. Rowe Price at age 95.[3]

As the largest TDF (more than 35 percent of all TDF assets), Vanguard's glide path often serves as an industry standard. Other glide paths are designed to reach the landing point as of the target date — implementing risk controls coincident with commencement of payouts.[4] Still other designs

[3] R. Wohlner, Target Date Funds Comparison — Aren't They All The Same?, 8/22/18. Accessed 9/17/18 at: https://investorjunkie.com/48359/target-date-funds-comparison/

[4] Morningstar, John Hancock Multi-Index Preservation Target-Date Fund Series Report, 6/30/18. The landing point is 8% upon reaching age 65. Accessed 9/17/18 at: http://news.morningstar.com/pdfs/STUSA05CL0.pdf

incorporate alternative glide paths designed to preserve the purchasing power of accumulated assets as of the target date yet provide for the growth of assets after retirement.[5]

Understanding the glide path is essential to recognizing the risks to participants. The transparency of a TDM makes the glide path transparent to participants so they can easily identify the risk involved in their target date allocation.[6]

Fees

Everyone in a traditional TDF is pooled into a mutual fund or a collective investment trust so reporting, accounting, and audits are all standardized. This unitization comes at a cost that simply goes away with TDMs. Historically, the average TDF fee was 90 basis points. One lawsuit was brought in December 2015 concerning a TDF that had fees of 53 basis points; those target date funds significantly underperformed alternatives, and included an added layer of fees in addition to the fees charged by the component funds.[7]

More recently, the demand to reduce fees has led to a flight to passive target-date series. The average asset-weighted expense ratio fell to 0.66 percent at the end of 2017.[8] The injection of more passive exposure within historically active target-date series and the launch of series that blend active and passive funds have contributed to that trend. As the TDM adds no cost to the investment management fees for the underlying core investment options, some TDMs have an all-in cost of less than 20 bps, placing them among the lowest cost offerings in the industry.

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[5] Target Date Solutions, SMART Funds® Target Date Index, Accessed 9/17/18 at: https://www.targetdatesolutions.com/SMART-TDF-Index.html

[6] S. Murray, Retirement risk: Don't trade downside protection for more upside, Russell Investments, 3/13/18, Accessed 10/15/18 at: https://www.advisorperspectives.com/commentaries/2018/03/13/retirement-risk-dont-trade-downside-protection-for-more-upside

[7] Pledger v. Reliance Trust Company, 240 F.Supp.3d 1314 (N.D. Ga., 2017), Accessed 10/15/18 at: https://www.leagle.com/decision/inadvfdco171116000364 As of 9/27/18, the court docket confirms litigation is ongoing, with 179 different entries!

[8] J. Holt, Morningstar, Note 1

A Model Portfolio Recordkeeping Service?

Your service provider may already incorporate plan administration and recordkeeping services which specifically provide for model portfolios. Model portfolios are pre-selected asset allocation strategies, often offering the risk diversification available in a target date fund, but usually at a lower cost. The model portfolio allocates assets across some or all of the core investment options otherwise available in the individual account retirement savings plan. The asset allocation for each target date model portfolio, the percent that is invested in each core investment option, is typically designed by an investment professional, then proposed to and adopted by your plan's investment fiduciary.

Service providers who deliver recordkeeping services for model portfolios are typically not involved in the construction or management of the model portfolios. Construction and management of the model portfolios includes determinations of:

- the number and type of model portfolios, including whether they are risk and/or target date based
- the asset allocation of the model portfolios, including changes to the asset allocation when appropriate or based on a glide path, if applicable; and
- the automatic rebalance schedule for the model portfolios

Generally, participant accounts are automatically rebalanced periodically to keep the account aligned with the target asset allocation of the model portfolio, based on the automatic rebalance schedule selected by the plan's named fiduciary, or plan's designated investment manager. When the account is rebalanced, a confirmation of the investment transfer/reallocation is sent to the participant.

Participant statements will report the positions and values of the investment options held in the account that make up the model portfolio. The account summary and statement will clearly identify the model portfolio in which the participant is currently enrolled.