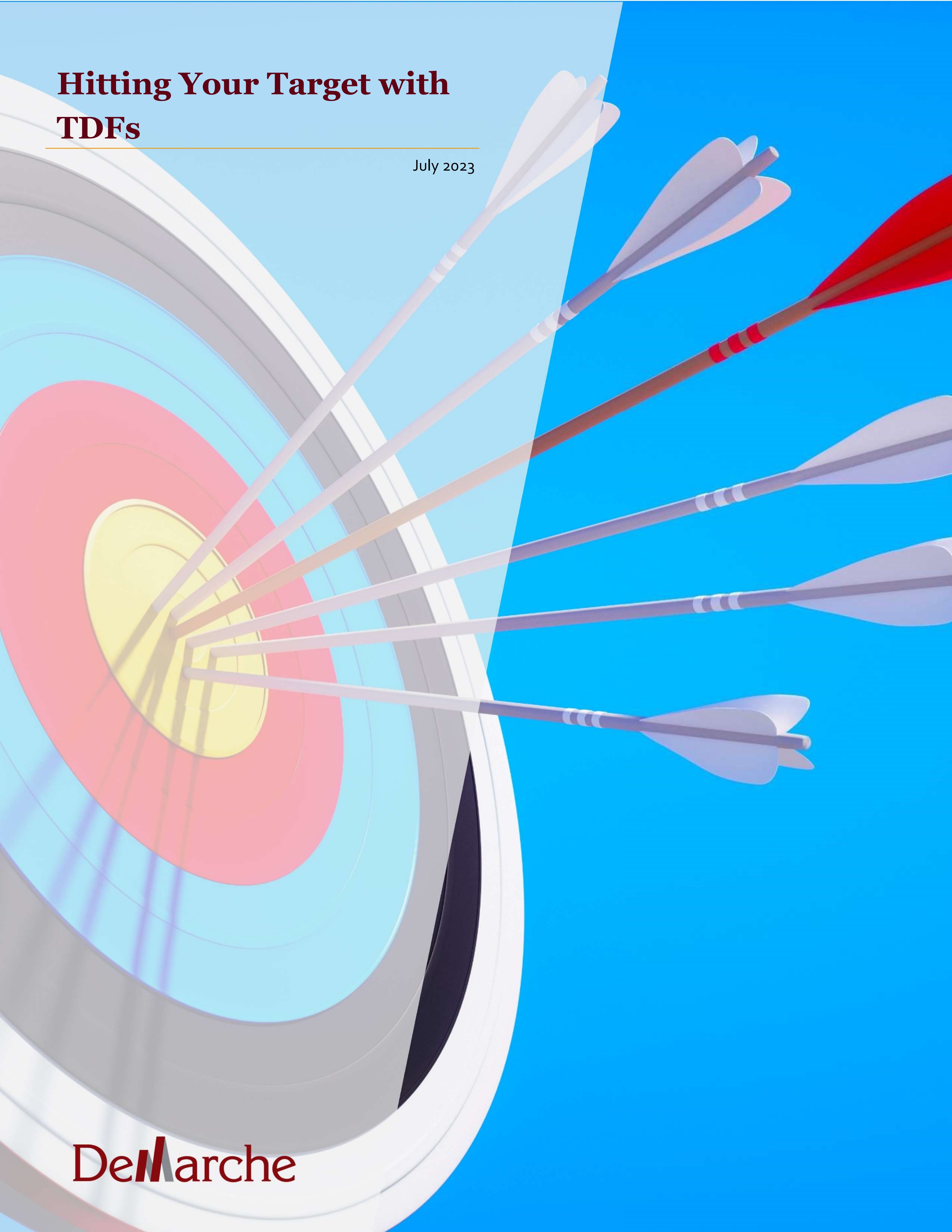
Hitting Your Target with TDFs

July 2023



DeMarche

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Point of Discussion

Abstract

Target Date Funds provide an effective way for individuals looking to save for retirement to invest in a mix of asset classes through a single fund that rebalances its asset allocation periodically. In this paper we will describe what target date funds are, explain the value in them, and discuss the ways these retirement investment vehicles have evolved since their inception in 1994.

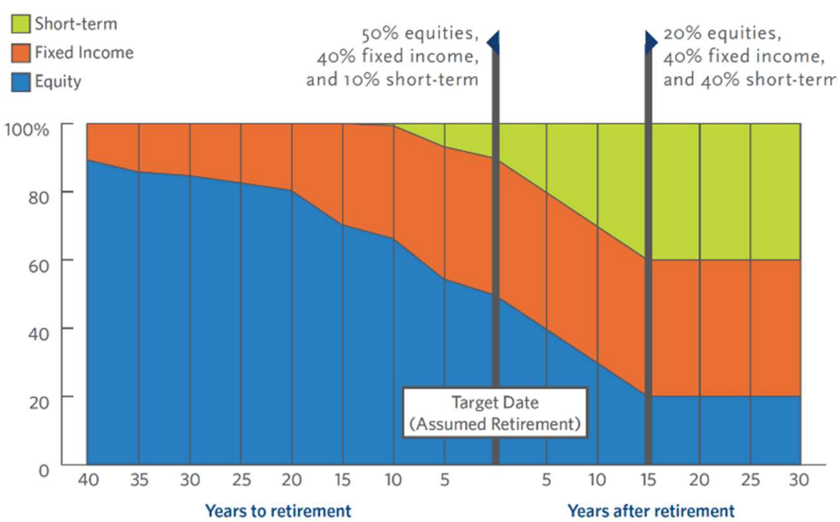
Many individuals saving for retirement do not have the time or expertise necessary to navigate a market environment with unique asset class opportunities and ever-changing risks. While no investment can address the fact that most Americans do not save enough to prepare for retirement, target date funds can offer a "one-stop" solution for investors seeking a balanced portfolio without the need for continuous monitoring.

What are TDFs?

A target date fund (TDF) is a strategy offered by an investment company that allows investors access to a diversified portfolio of asset classes, managed along a "glide path" to retirement. TDFs typically rebalance assets periodically to maintain a target asset allocation, so large swings in the market may have a mitigated impact on total return over extended time periods.

Along with periodic rebalancing, TDFs also reallocate assets over a longer period of time in an attempt to build capital in the early years by focusing on investments with a higher risk/reward profile, then retain those gains by shifting towards safer choices as the target date approaches. An example glide path is shown in Figure 1. The main reasoning behind an age appropriate asset allocation design is that investors can try to mitigate investment risks incurred with time and human capital risk the farther out they are from the fund's target date.

Figure 1: An Example Glide Path



Source: Investment Company Institute

Fund providers typically offer TDFs with target dates spaced at five-year intervals to meet the needs of investors across a wide range of ages. There are also two types of TDFs available, which differ on investment activity once the target date is reached. A "through fund" will continue rebalancing its asset allocation toward typically more conservative holdings, such as short fixed income, after the target date. A "to fund" will retain its final asset allocation indefinitely at its target date.

TDFs can also take a fully active approach by utilizing only active managers, a fully passive approach by only investing in index funds, or a hybrid approach where they invest in a blend of both throughout the fund's glide path. Regardless of whether they are labeled active, passive, or hybrid in implementation, all TDFs are managed actively from a glide path standpoint.

The Hands-off Approach

By providing strategic asset allocation positioning and ongoing oversight in a single fund, TDFs perform well for those who have neither a good understanding of investment strategy nor the time to continuously monitor their investments. Though investment expertise has not necessarily waned, the population in need of a solution that offers these benefits is attractive to many asset managers.

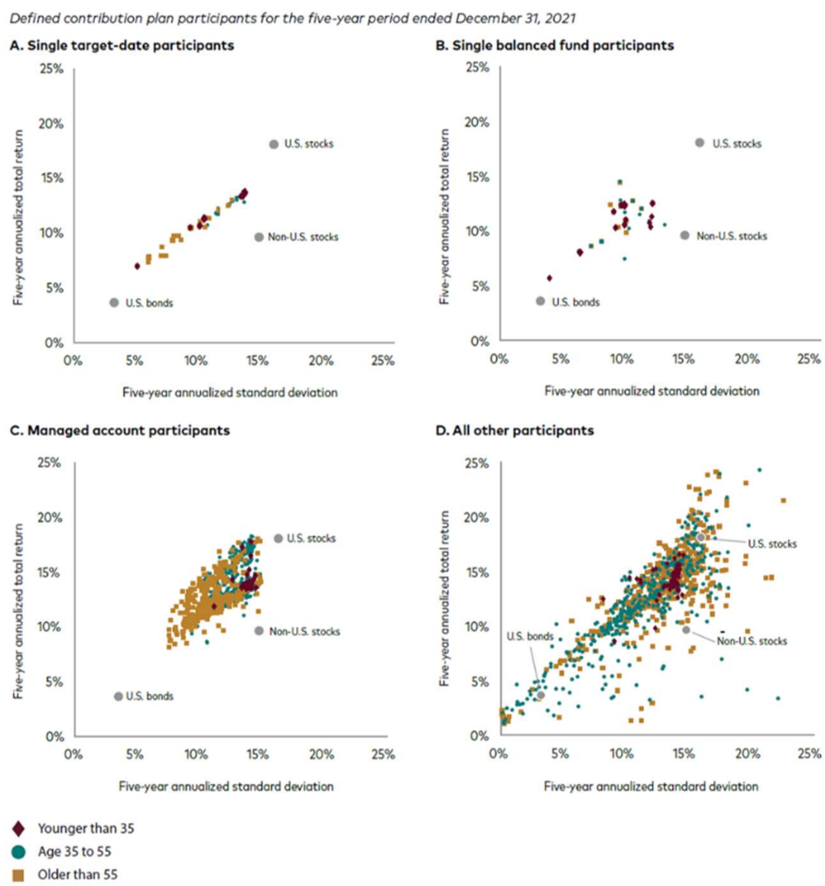
Of the five million participants in defined-contribution plans managed by Vanguard, only 15% did any active trading in 2021, down from 20% in 2004.

Much of this is due to decision fatigue. According to FINRA, the average plan offers between eight and twelve investment options. Though having access to several options can be valuable to employees, when faced with a long list of options many investors can become overwhelmed with how to balance their retirement assets (see our previous paper on Choice Paradox), and how this should change over time. Choosing a TDF allows for this responsibility to be shouldered by an investment manager, often saving retail investors' from themselves.

Another reason for the lack of trading is because of retail investors' inability to consistently adapt to the changing landscape of today's investing environment. TDF managers typically formally address their glide path structure at least annually, making minor adjustments based on current and expected market conditions. This can be a benefit for an investor without the knowledge to adjust to such events.

Proof of the value of the TDF approach take can be seen in the risk and return characteristics seen in Figure 2. Using random samples of Defined Contribution plan participant accounts at Vanguard, we can see through a five-year annualized total return (y-axis) and standard deviation (x-axis) chart that participants using a single TDF prove to bring more consistent, reliable returns than all other participants.

Figure 2: Risk and Return Characteristics (2017-2021)



Past performance is not a guarantee of future returns.

Note: Includes 1,000 random samples of participant accounts drawn from respective samples. Excludes 0.5% top and 0.5% bottom outliers for both risk and return, for a net sample of 980 observations.

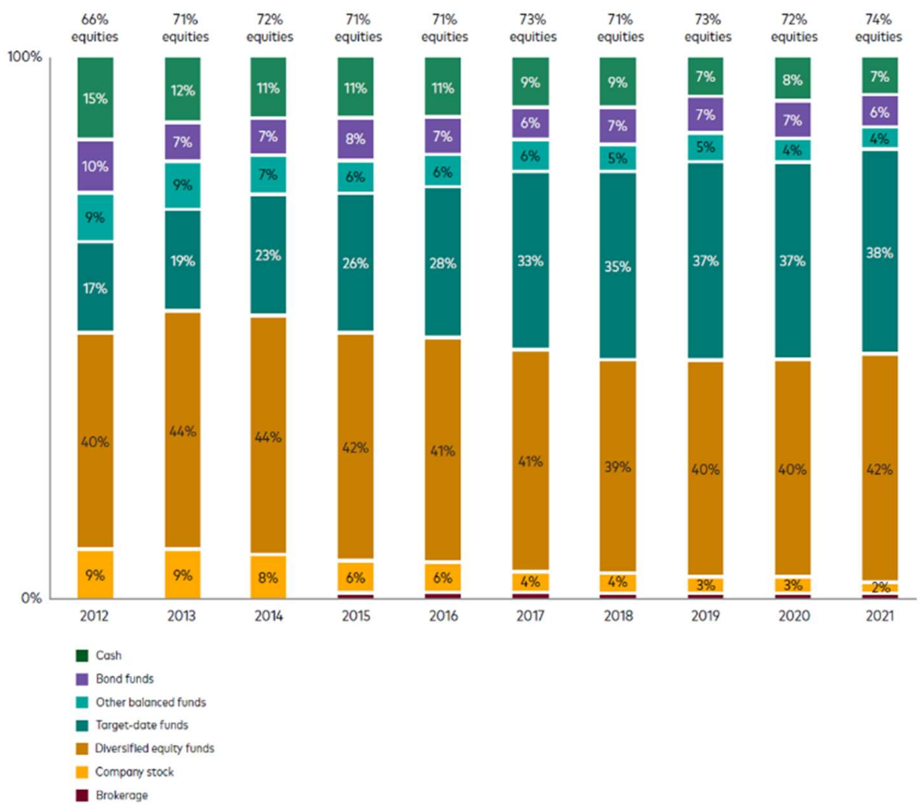
Source: Vanguard 2022.

From 1994 to Now

First created in 1994, TDFs have experienced rapid growth in the past decade. At year-end 2021, 95% of plans offered TDFs, up from 84% in 2012. TDFs hit a record $3.27 trillion in assets in 2021, according to

Figure 3: Plan Asset Allocation Summary

Vanguard defined contribution plans

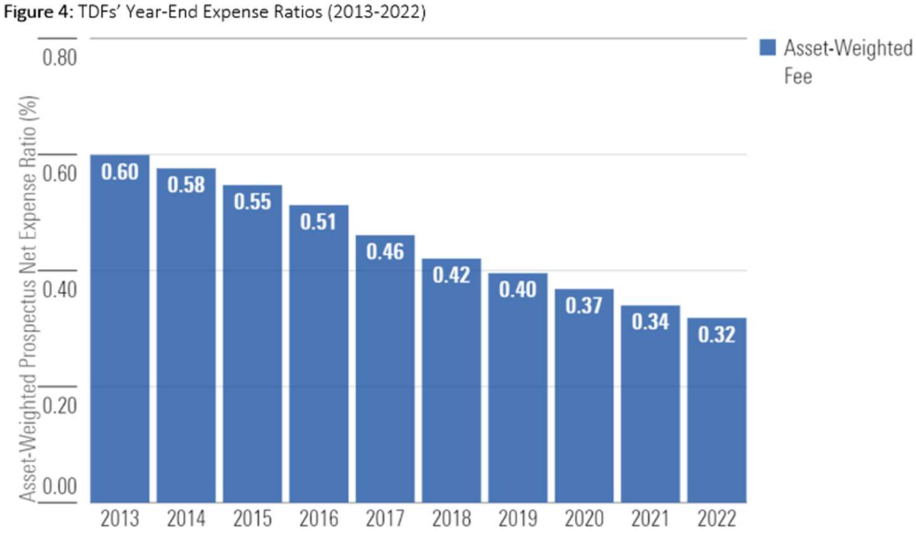


Source: Vanguard 2022.

Morningstar's "2022 Target-Date Strategy Landscape" report. As shown in Figure 3, TDFs have increased to comprise 38% of total plan assets in Vanguard defined contribution plans, up from 17% in 2012. This unprecedented growth in utilization can be attributed to three primary reasons.

First, the growing use of automatic enrollment by plan sponsors into default investments rather than plan participants making their own active investment choices is the primary reason. The adoption of automatic enrollment has more than tripled since 2007. At year-end 2021, 56% of Vanguard plans had adopted automatic enrollment. Of the plans that have adopted automatic enrollment, 90% have designated TDFs as the default investment, up from 68% in 2012. The Secure 2.0 Act, which was signed into law on December 29, 2022, requires that all new 401(k) and 403(b) plans established after December 31, 2024, offer automatic enrollment and auto-escalation. This will likely force the issue further.

Figure 4: TDFs' Year-End Expense Ratios (2013-2022)

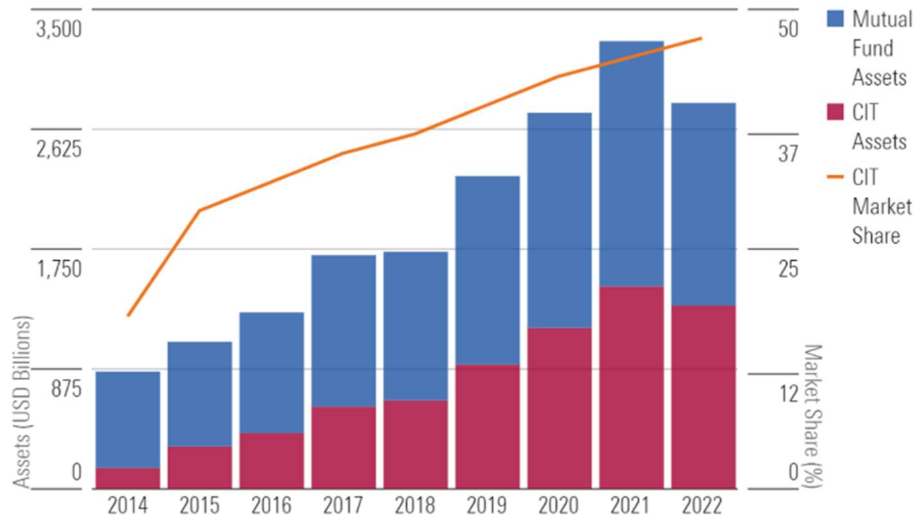


Source: Morningstar Direct and author's calculations. Data as of 12/31/2022. Excludes zero-fee share classes.

Second, TDFs have become much more reasonably priced over the years. The average asset-weighted fee for target-date funds was 0.32% in 2022, down from 0.46% in 2017 and half of what it was in 2009. Further detail of the change in TDFs' Year-end Expense Ratios can be found in Figure 4.

Finally, the rising popularity of collective investment trusts (CITs) has helped make TDFs more affordable. In 2021, CITs collected 79% of the TDFs' $153 billion in net asset inflows. As shown in Figure 5, CITs make up 47% of TDF assets as of the end of 2022, and are projected to become the most popular TDF within the next two years according to Vanguard. CITs are generally lower cost and exempt from certain regulatory requirements faced by mutual funds.

Figure 5: Total Target-Date Assets



Source: Morningstar Direct, author's calculations, and surveyed data. Data as of 12/31/2022.

Conclusion

TDFs are a common and convenient way for individual investors to maintain a strategically balanced portfolio and age appropriate asset allocation positioning in a single strategy. It is important however for plan sponsors to actively monitor the TDF provider selected as a fiduciary duty to their employees. In periods of dramatic capital appreciation like we saw in 2021, followed by an immediate downfall in the equity market like we saw in 2022, making just one decision up front in choosing a target date fund may have proved to be a valuable decision.

Sources Utilized:

- *Charles Schwab*
- *FINRA*
- *Investment Company Institute*
- *Morningstar*
- *Vanguard*

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