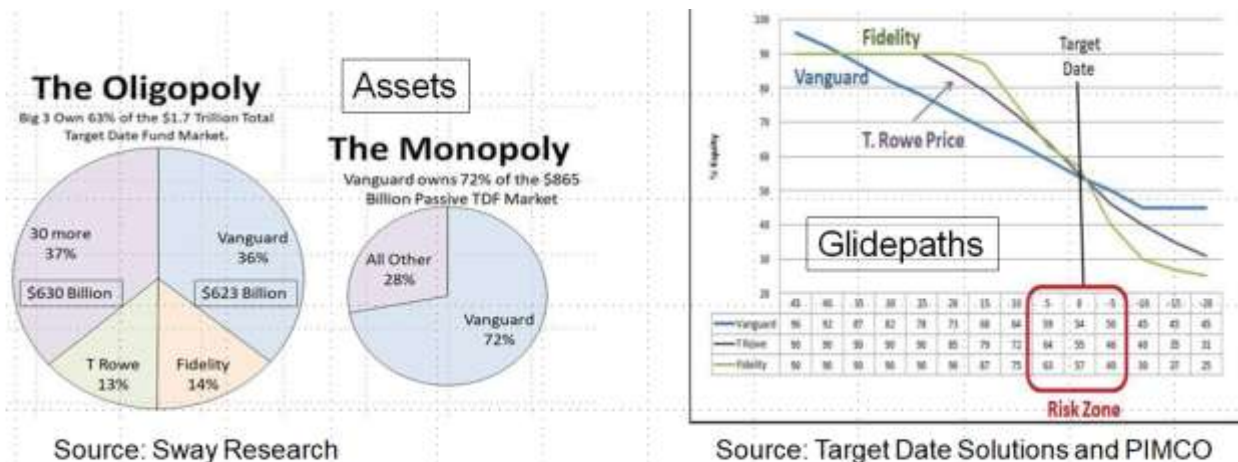
Advances in the Form and Function of Target Date Funds

- Personalized model accounts are advancements in the Form of TDFs that solve the one-size-fits-all problem. Asset protection in the "Risk Zone" is an advanced Function that reduces the risks that plagued 2008.
- The $2 trillion TDF industry is dominated by an oligopoly of 3 firms that manage 63% of the assets, stifling advancements.
- Fiduciaries should seize the opportunity to do what is prudent and wise. It's their duty. You don't need the oligopoly, or any other existing TDF, to implement improved Form and Function.

I'll be speaking on a panel at the upcoming PSCA (Plan Sponsor Council of America) national conference in May. The Mission of PSCA is to "***Solve real problems, create positive change, and expand on the success of the employer-sponsored retirement system."*** The following is a description of my presentation. Plan sponsors should consider alternatives to the *status quo* because TDFs are still in their infancy, and evolving. They're just getting better.

Snapshot of the Current Target Fund Industry



Source: Sway Research

Source: Target Date Solutions and PIMCO

Vanguard, Fidelity and T Rowe Price "own" the TDF market. The combined market share of the other 30+ competitors is about the same as Vanguard's $623 billion. These "Big 3" meet the definition of an oligopoly since they are "*a few producers who control the*

*majority (*in this case 63%) *of the market share and typically produce similar or homogenous products.*" Oligopolies are generally not good for consumers for a variety of reasons.

This oligopoly began with a preference by plan sponsors to choose their bundled service providers for their TDFs out of convenience and familiarity, and bundled service providers encouraged this choice by charging a premium to administer TDFs they did not manage. As time went on, these Big 3 became standards, especially Vanguard, as detailed in Target Date Fund Benchmarks; you have choices for benchmarking TDFs. Vanguard has even become a legal standard in court hearings like the Putnam case.

As shown in the graph above, the investment risks of the oligopoly's glidepaths differ somewhat over time but are identical at the target date with 55% in equities. This is the equity exposure that lost more than 30% in the 2007-2009 market meltdown. Individual Retirement Accounts (IRAs) are also exposed to excessive loss in the Risk Zone. The Employee Benefits Research Institute (EBRI) report on IRAs reveals that equity allocations are approximately 55% across all ages, a surprising reality. This is likely a reflection of the 60/40 standard, where 60% equities and 40% bonds approximates market weights.

This oligopoly stifles innovation because 3(38) advisors/fiduciaries believe that they take serious business and legal risks if they do not use the Big 3. It's like mainframe computers in the 1970s when the mantra of purchasing agents was "You can't go wrong with IBM." This creates a conflict between advisor self interests and beneficiary objectives that seek more safety than the Big 3 provide. Ideally the two interests could be aligned as discussed in the "Function" section below – both advisors and beneficiaries can be protected with a new advancement in glidepath design. A new "Form" of TDF facilitates adoption of this innovative "Function" of a glidepath.

Making TDFs Better

Both the Form and the Function of TDFs could be much better for beneficiaries. The current Form is one-size-fits-all mutual funds and collective investment trusts. Personalized model accounts (PMAs) are an improved Form that solves the one-size fits-all problem, and can also solve the current Function problem that emphasizes

growth over safety. A better Function emphasizes safety over growth in the transition from working life to retirement, known as the Risk Zone.

There is little disagreement that one-size-fits-all is a major shortcoming of TDFs. Functionally, oligopoly TDFs, as well as most other TDFs, do not protect beneficiaries in the Risk Zone that spans the 5-10 years before and after retirement. We argue in the "Protection" section below that the Function of TDFs should be to protect beneficiaries. Beneficiaries and fiduciaries both want protection. Fiduciaries mistakenly believe that the oligopoly protects them against lawsuits, but the fact is they are breaching their duty of care by not thoroughly vetting their TDF selection. Advanced TDFs are rarely even considered.

Personalized Model Accounts: A Better Form

Because everyone is unique with unique circumstances and needs, one-size-fits-all simply does not work. Current solutions to this problem are "Custom" TDFs and "Hybrid" plans. Custom TDFs are still one-size-fits-all so even though they might lessen the problem they fall far short of fixing it.

"Hybrid" plans roll older beneficiaries out of TDFs and into Managed Accounts. This can work if the Managed Account is face-to-face personal advice, but this is rarely the case. Most managed accounts are automated, or so-called Robo advice. Defaulted participants are highly unlikely to engage with automated advice.

A relatively new approach is to create Personalized Accounts that track each participant's chosen glidepath using funds that are on the 401(k) platform. They're like managed accounts with a lifetime game plan. The recordkeeper is the key to maintaining personalized accounts. The recordkeeping system "sees" the allocation on a chosen glidepath as if the participant had elected that allocation, and rebalances accordingly.

Defaulted participants are placed on a glidepath selected by the plan sponsor. We recommend a conservative choice in keeping with the Function of protecting savings discussed in the next section. Non-defaulted participants can choose from a family of glidepaths (say conservative, moderate and aggressive) and can change glidepaths at will. They should be encouraged, or restricted, to not mix glidepaths with other fund

options. Defaulted participants might also be given access to managed account advice that guides them to an appropriate glidepath for their needs.

In addition to solving the one-size-fits-all problem, personalized model accounts can be substantially less expensive than traditional TDFs. In one real live implementation the all-in costs are less than 10 basis points. PMAs are not just hypothetical. They can and have been implemented in practice.

PMAs are also more precise regarding the participant's planned retirement date. Each participant can stipulate that date and is not grouped together with other defaulted participants in 5- or 10-year age bands, as is the current Form.

Personalized accounts provide an improved Form of target date investing that ideally use glidepaths with improved Functions.

TDF Function is Protection, but Whose Protection?

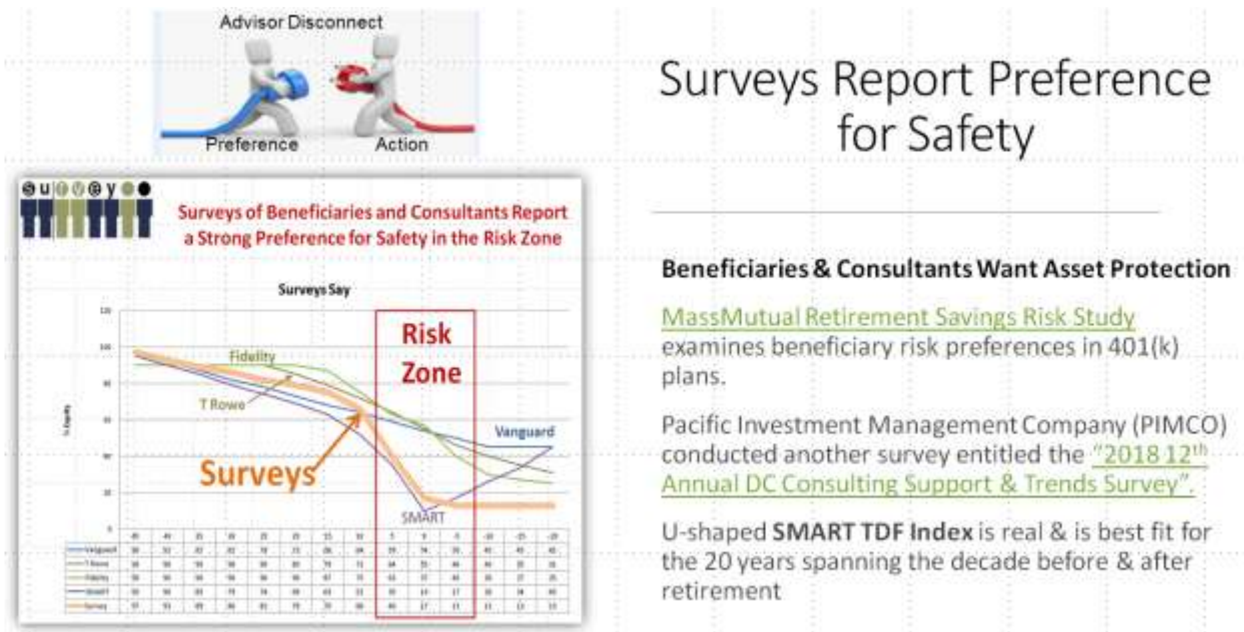
Everyone wants to be protected – that's the one objective everyone agrees on. Fiduciaries want to be protected from lawsuits and their attorneys tell them that procedural prudence provides this protection, so they choose the Big 3 because everyone else does. It is "wisdom of the herd" complacency. The 30+ competitors to the Big 3 are scrambling for the crumbs.

Surveys report that beneficiaries also want to be protected, but from investment losses. 2008 revealed that beneficiaries mistakenly believe that their employers provide this protection in choosing a Qualified Default Investment Alternative (QDIA) , but this is not true although it should be. Defaulted beneficiaries could know the risk they are taking by looking at their account statements, but most don't. Personalized accounts could help by disclosing the individual holdings along the glidepath. But even if they see risk they do not like, beneficiaries only recourse is to not default or to get their employer to select a different TDF, neither of which is practical. The key is to get the risk "right" in the first place.

There's a conflict of interest. The net result is that neither party is getting the protection they desire. Fiduciaries violate their duty of care by exposing beneficiaries to avoidable harm, so they are not protected from lawsuits. Beneficiaries think they're okay, but will

be shocked in the next market correction. The only winners in this industry are the fund providers, especially the oligopoly, who are raking in fortunes.

To put fiduciaries and beneficiaries in the winner's circle, risk needs to be reduced in the Risk Zone. The advanced Function of TDFs is Safety near retirement, like less than 20% in equities and most of the balance in safe assets like Treasury bills. Surveys of beneficiaries and advisors confirm that both want safety near the target date, as shown in the following exhibit. The SMART Index shown in the exhibit is explicitly designed for this protection.



There's a supporting reason for low risk near the target date. Research into the optimal glidepath in retirement finds that it is optimal to begin at 10-20% in equities and to gradually re-risk to 30-40% over the following 30 years. So say Dr. Wade Pfau and Michael Kitces in their ***Reducing Retirement Risk with a Rising Equity Glide Path***. The safe beginning protects against sequence of return risk and the re-risking extends the life of investments, helping them last a lifetime. Beginning retirement safely means ending working life safely as well since one leads into the other.

And there's a third reason for safety near retirement. There are 75 million baby boomers in the Risk Zone at a time when the next major market correction is threatening. These older folks won't recover from the next correction even if capital markets rebound.

That's the nature of sequence of return risk. So this reason is a blend of market timing combined with risk management. We may never again see the confluence of millions of people exposed to impending danger all at the same time.

Summary

Target date funds can and should become a lot better. Personalized model accounts solve the current one-size-fits-all problem, and U-shaped glidepaths solve the excessive risk problem. The U is very low equity exposure near the target date, with increasing risk on either side of it. Both the PMA and the U-shape are being used in practice by at least one 401(k) plan, so it's beginning.

Will these advancements be broadly adopted? The existence of an oligopoly does not bode well for this, but time will tell. Fiduciaries should seize the opportunity to create truly customized safe glidepaths for their beneficiaries because they like their employees and protecting them is the prudent thing to do.

The beauty is that you don't need the Big 3 or the other 30+ TDFs in order to implement these advancements to the Form and Function of target date funds.

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