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COVER STORY

Five Life Events that Cause Employees Significant Stress

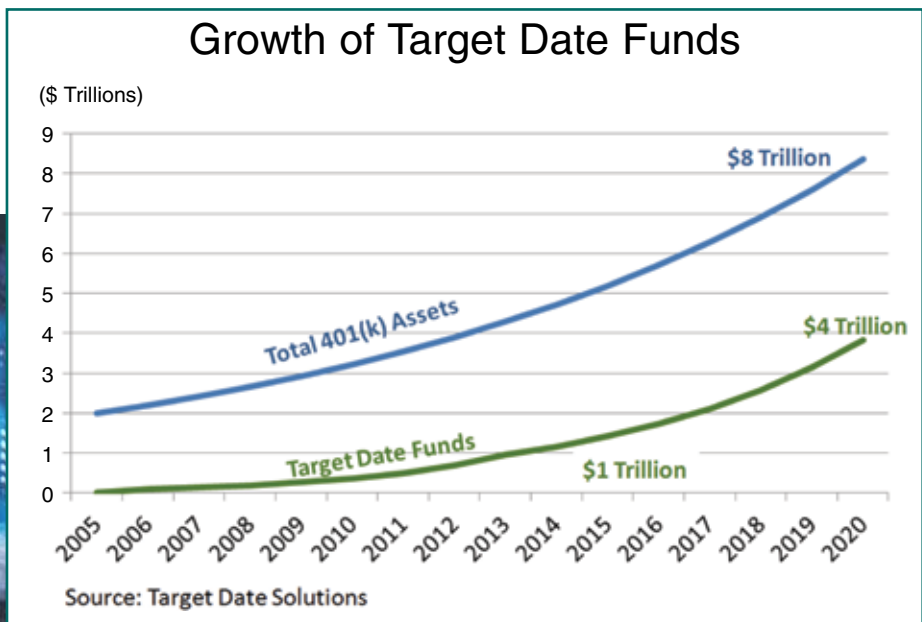
Jeanne Thompson, Fidelity Investments

Combining Target Date Funds with Managed Accounts to Create Personalized Target Date Accounts



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Because they are the most popular Qualified Default Investment Alternative (QDIA), target date funds (TDFs) are the fastest growing investment in 401(k) defined contribution (DC) pension plans, projected to grow to \$4 trillion by 2020, from their current level of \$1 trillion. That's 40% per year growth over the next four years. On a percentage basis, TDFs will increase from 25% of all 401(k) assets to about half.



There currently are 20 million participants in TDFs across 100,000 401(k) plans, and new participants default into TDFs every day. Approximately half of all new contributions are going into TDFs, and this percentage will increase to over 60% in just a few years, according to research by Cerulli Associates.

But despite their popularity, TDFs cannot meet the needs of most participants because they are one-size-fits-all. After all, we are all unique, with divergent financial situations, needs and wants. Even custom TDFs suffer from this one-size-fits-all inadequacy. Advocates claim that TDFs are better for participants than leaving them on their own, but that is not saying much.

To address the one-size-fits-all problem, managed accounts are personalized to the individual participant and serve as the second most popular QDIA.

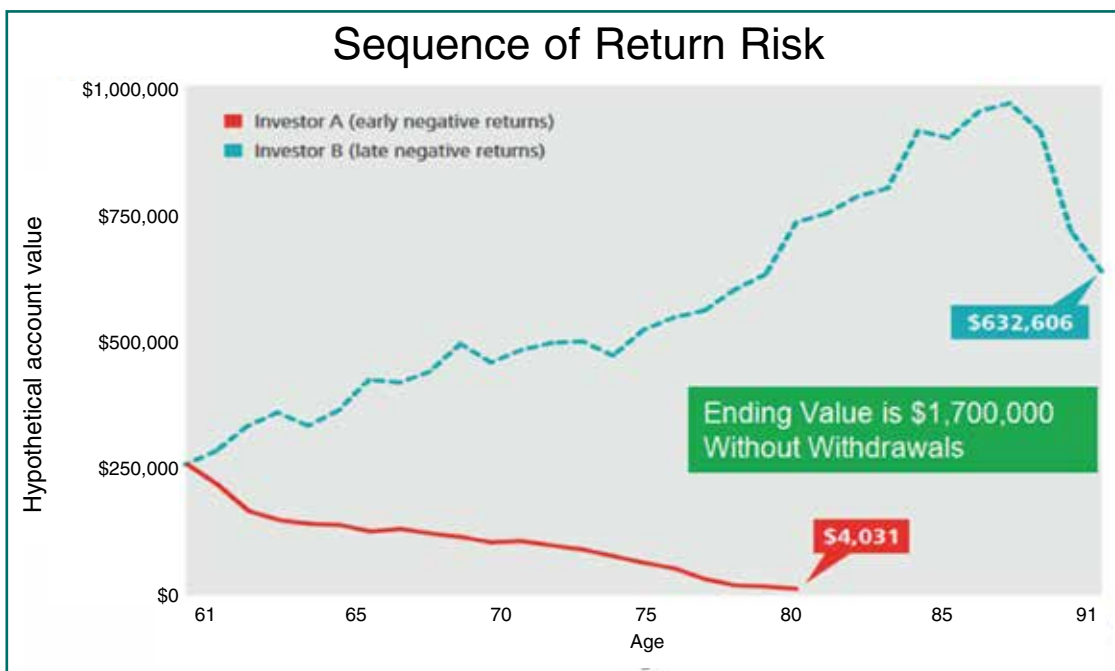
This article describes an approach that combines TDFs with managed accounts to create Personalized target date accounts, or PTDA. PTDA are customized to each participant’s circumstances and goals. Managed account providers help participants identify appropriate risks, customizing risk exposures along the best TDF glide path. Recordkeepers manage allocations to personalized age-and-risk-appropriate models.

In the following, we discuss managed accounts, target date funds, and the marriage of the two that creates PTDA.

Managed Accounts

Managed accounts are both art and science. The art is determining an investor’s risk capacity. The science is creating an asset mix with the highest expected return for the investor’s desired risk. The best managed account is face-to-face individual consulting, but this is expensive, so one-on-one managed accounts are generally limited to the executives of companies. Inexpensive managed accounts for the masses are available through so-called “robo advisors” that provide computerized automated guidance.

The art of identifying risk capacity is related to temperament and age. Some of us are risk takers, but most of us are risk averse. Age plays a critical role because there is a risk zone that spans the 5-10 years before and after retirement during which safety is paramount because lifestyles are at stake. Specifically, there is a well-documented concept called “sequence of return risk” that is highest in the “risk zone” as shown in the following:



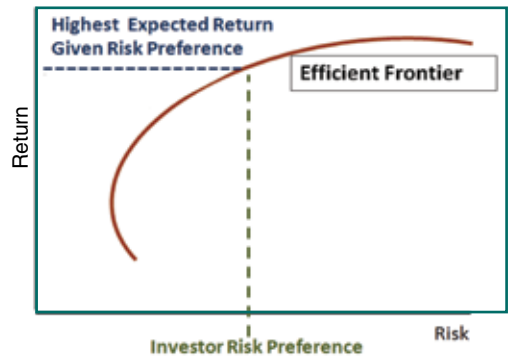
This chart shows two 30-year income scenarios. The solid line shows a withdrawal plan that started off with three years of negative returns in a row. The dotted line represents a withdrawal plan with the negative years at the end. Both plans started with \$250,000 and both took out \$12,500 per year increased by 3% for inflation. No other actions were taken to manage income withdrawals. Both plans had a 6.6% average annual rate of return on the underlying investment for the 30-year period.

Source: MFS Research

Combining Target Date Funds with Managed Accounts to Create Personalized Target Date Accounts

Once risk tolerance is determined, Modern Portfolio Theory (MPT) is used to locate the “right” asset mix on the efficient frontier, as shown in the graph on the right. Through the magic of diversification, this solution produces a portfolio with the highest expected return for the investor’s risk level.

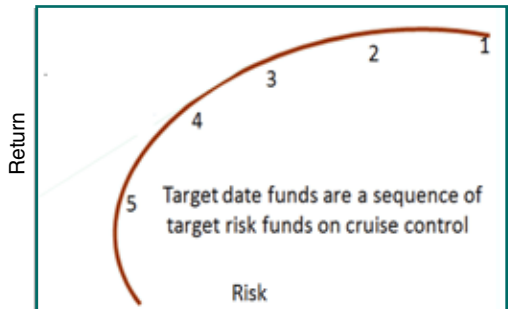
Some managed accounts are better than others, although all proceed as described here. Similarly, despite their similarities, TDFs vary widely based on their glide paths, as discussed in the next section.



Target Date Funds

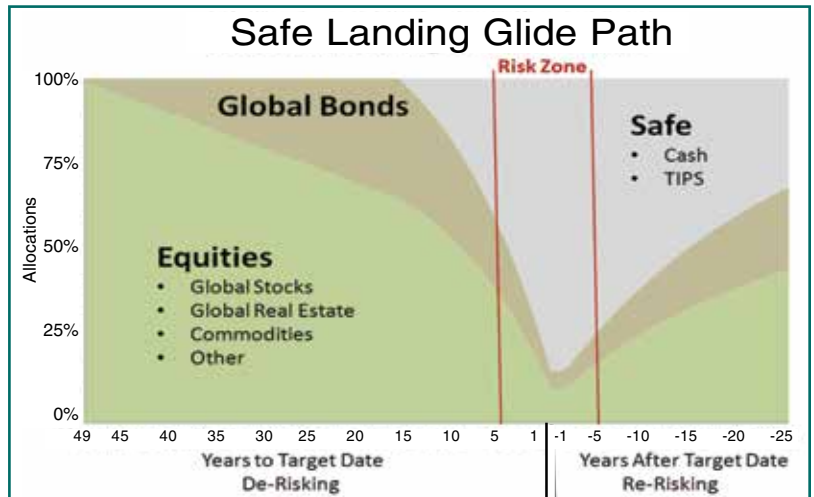
Target date funds can be viewed as a sequence of target risk portfolios on cruise control, as shown in the graph on the right. In this graph, portfolio 1 is the riskiest and designed for young participants, while portfolio 5 is the most conservative and is designed for older participants. You would think that this “glide path” would have been standardized by now but it has not.

The first steps in creating Personalized Target Date Accounts are to find the best managed accounts and the best TDF glide path. The best TDF glide path in our opinion is the patented Safe Landing Glide Path[®]. This glide path is unique and superior in the following ways:



The Best Glide Path is “To-and-Through”

- Extensive diversification at long dates for younger employees.
- Very safe at the target date, with more than 90% in short-term treasuries and TIPS.
- Uses two Nobel-prize winning theories coupled with liability-driven investing and risk-of-loss analysis.
- Employs a “To-and-Through” bounce-back glide path with increasing equity allocations in retirement. This unique U-shape defends against sequence-of-return risk that is at its peak in the risk zone spanning the five years before and after retirement. It also recognizes that retirees need to hold some equities.

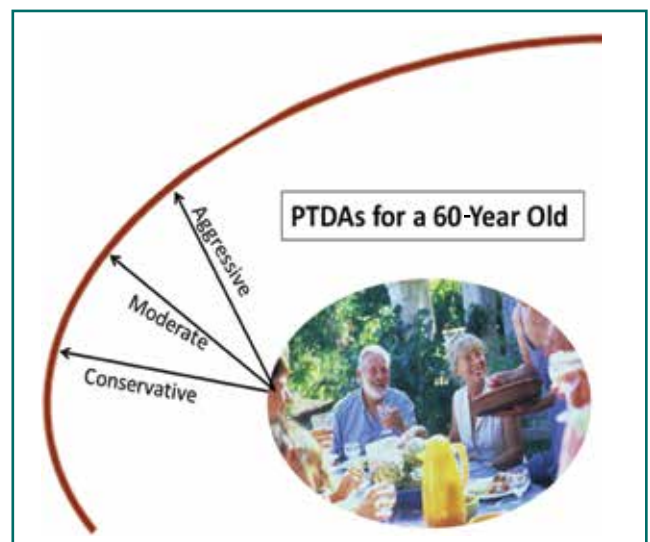


The next step is to marry the best TDF glide path and the best recordkeeper for managed accounts as described in the next section.

Personalized Target Date Accounts

PTDAs integrate individual risk preferences with allocations along the glide path, as exemplified for a 60-year old in the graph on the right. As you can see, there are three risk preferences associated with each age in the target date fund glide path.

The Department of Labor (DOL) recommends the incorporation of workforce demographics into TDF design. This can only be accomplished with individualized choices. Some participants will have savings outside the DC pension plan, so they don’t need to generate high returns, arguing for conservatism. Others might not have saved enough, so they require higher investment returns associated with aggressiveness.



A skillful and competent recordkeeper is the glue that cements TDFs with managed accounts to create PTDA's. Each participant has a unique mix of risk preference and age that the recordkeeper uses to allocate to the appropriate asset mix.

Cost Savings from Removal of Unitization

Unitization is the reason that TDFs are one-size-fits-all. Everyone in a TDF is pooled into a mutual fund, collective investment trust, or a model portfolio so reporting, accounting and audits are all standardized. This unitization comes at a cost that simply goes away with PTDA's. With an average TDF fee of 90 basis points, if the plan sponsor uses low cost funds in their PTDA's, we estimate that all-in costs could be reduced below 20 basis points, placing it among the lowest cost funds in the industry. Fees currently range from a low of 15 basis points to well over 100 bps. Some may say that this removal of standardization is a problem, but it is a natural consequence of personalized revisions on solutions, including managed accounts. In addition to reducing costs and meeting the risk preferences of individual participants, PTDA's more accurately manage to each participant's age.

Individualized Time-to-Retirement Allocations

Traditional target date funds group participants by age. For example, participants currently in 2020 funds are ages 57 to 67, who will be ages 60 -70 in 2020. In other words, TDFs are only partially customized to participant age. This lack of customization matters most near the target date because the transition from working life to retirement is critical to lifestyle in retirement.

This shortcoming is remedied by tailoring personalized target date accounts to each participant's anticipated time to retirement.

In our 2020 example, a PTDA locates today's 57-year old on his/her glide path at eight years from retirement while the 67-year old is seen as having retired two years ago. This is a very fluid approach that, when coupled with risk-based glide path choices, brings customization to its ultimate level. All allocations are fluid, and not constrained to age cohorts.

So why aren't PTDA's widely used?

Here are a few reasons:

- The tradition of target date funds is unitization, namely mutual funds and collective investment funds. Quite simply, it's the way it's always been done because it's what mutual funds and trust banks do.
- Maintenance costs like audits and regulatory reporting for mutual funds and collective investment funds are high, so marketing focus is on existing products.
- Only a few recordkeepers can do the necessary work for a reasonable fee. It's complicated.
- It takes a lot of time and effort to build something new and better. The difference between pioneers and settlers is the arrows in the back.

Conclusion

Personalized target date accounts integrate the best in target date funds with the best in managed accounts to create solutions that are tailored to the individual participant. This is a remarkable breakthrough and a destructive innovation that provides the following benefits:

- **Tailored** to the individual participant's needs and wants.
- **Lower ongoing expenses:** PTDA's are significantly less expensive to operate because they do not pay trustee, audit and legal costs associated with TDFs.
- **Reduced start-up costs:** Because the recordkeeper accepts responsibility for periodically rebalancing the PTDA as part of its contract, PTDA's do not incur significant upfront investments otherwise required for unitization.
- **Branding advantages:** PTDA's should not be subject to the significant branding constraints imposed upon TDFs so it may be possible to include names of sponsors in PTDA's. (e.g., Smart Union Target Date Accounts)
- **Superior prudence:** Anything that is better for participants is better for plan sponsors, from both a legal and ethical perspective. Also, PTDA's follow the DoL's recommendations to incorporate demographics and to consider customization. ■