An Up Close Look at Target Date Lifecycle Funds

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The Department of Labor's (DOL's) new rules for Qualified Default Investment Options (QDIAs) advance three investment options: Target Date Funds, Balanced Funds and Managed Accounts. "Managed Accounts" in this context means that a service provider creates diversified portfolios of the plan's mutual funds (and/or other offerings) on behalf of the participants.

Managed accounts hold the most promise for advisors but they require adherence to an audited prudent investment process, a process that could take years to achieve scale. Thus, Target Date Funds (TDFs) are the immediate play. Advisors will be called upon to find the best TDFs. But unfortunately, or perhaps fortunately for the opportunistic, current offerings are not as good as they could be.

The target date industry is still in its infancy and is likely to evolve very rapidly, if for no other reason than the probable stampede into these funds. The potential growth in assets committed to target date funds over the next 5-10 years is astounding. For example, at year-end 2006, there were 168 distinct target date mutual funds with $109 billion in total assets (if counting all share classes, the total number of funds was over 1,200). As of December 31, 2007 there were 229 target date funds with $178 billion in assets. This represents a 36% increase in the number of funds and a 63% increase in total target date fund assets in just 12 months.

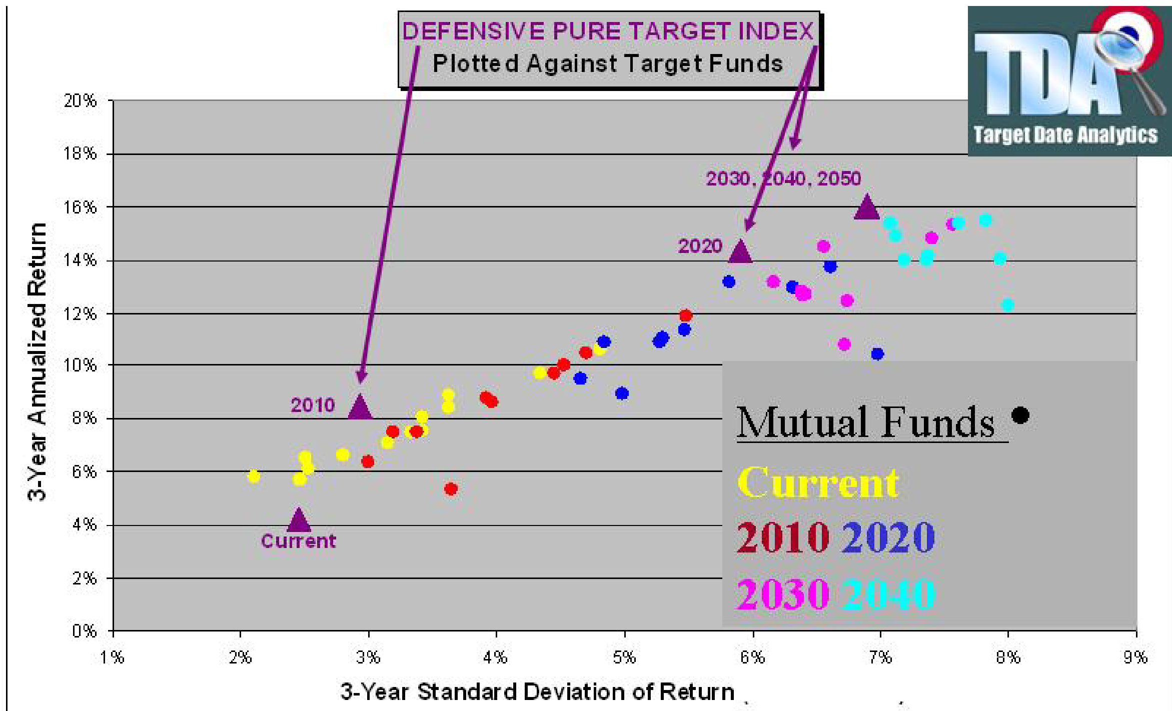
Even so, the ability to separate the wheat from the chaff is extremely difficult, primarily because there are no good yardsticks for gauging performance. That is the reason that my company, Target Date Solutions (TDS), was formed: to develop better glide paths

for TDFs, which can be used to ealuate TDFs. In the following I share our research on the performance of target date mutual funds and introduce the benchmarks we use to perform these evaluations.

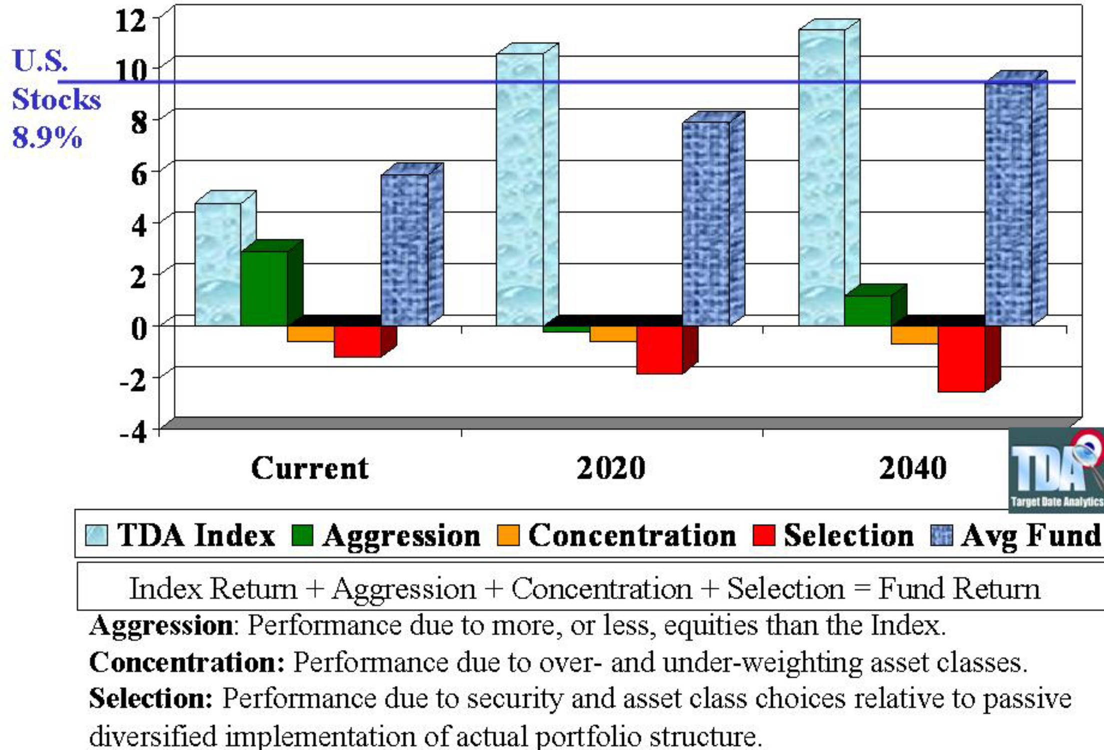
The appeal of a good target date fund is simple sophistication. Investors in good target date funds are like Lexus car buyers – they don't want to look under the hood. TDS's Safe Landing Glide Path is simple and sophisticated in the following two ways. First, an investor who enters at any time is highly likely to earn a positive real (above inflation) return if he or she stays in the index to the target date. Second, subject to this 1st primary objective, the index delivers the most return per unit of diversified risk that it can.

Some say that if "best practices" are not common practices they are merely someone's opinion of how things ought to be. You be the judge. The next exhibit shows the risk-return profiles of all target date mutual funds with 3 years of data, and contrasts these to comparable risk-return profiles of our recommended benchmark series, which sets a separate index for each target date. The dots in the exhibit are mutual funds, color coded by target date. The indexes are shown as purple triangles, with target dates indicated above the triangles. As you can see, the further the target date the higher the risk and the return of the mutual funds, so they have behaved as expected, reducing risk as target date nears, with the attendant reduction in reward. You can also see that the recommended index series has earned higher returns for the same levels of risk as the mutual funds. The fact that the indexes have performed better on a risk-adjusted basis is an indication that there is room for improvement in target date mutual funds, in our humble opinion.

Target Date Risk-Reward for 2005-2007



To better understand the sources of this poor mutual fund showing we have conducted an extensive attribution analysis of these funds. This first-of-its-kind study covers 92 funds, 15 fund families, and $161 Billion. A quick overview of our findings is presented in the next exhibit.

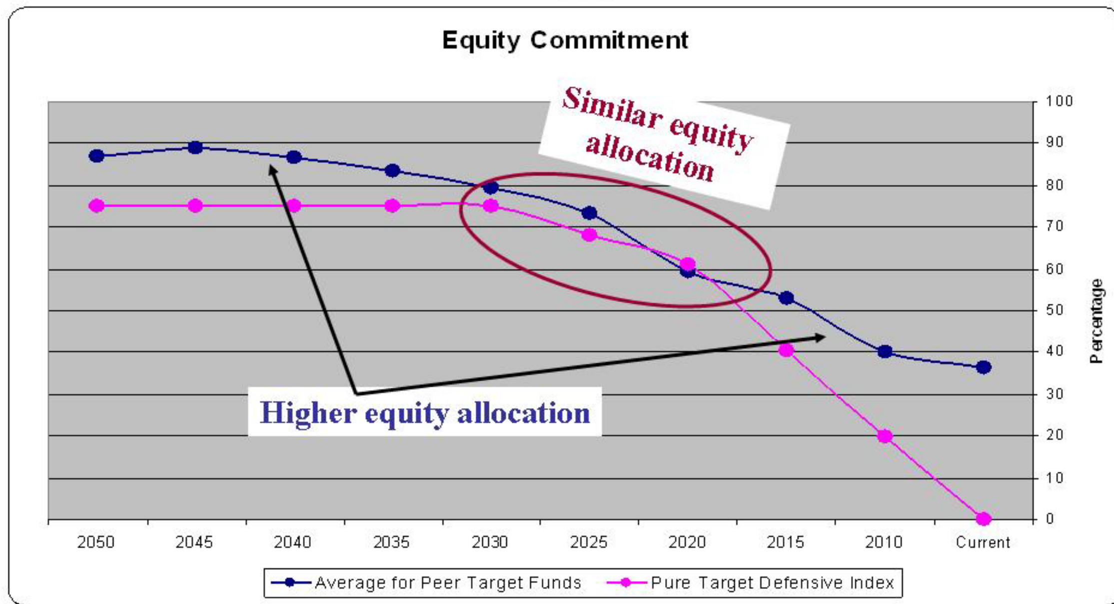


The "TDS Index" in the exhibit is our signature Safe Landing Glide Path. We calculate the "Selection" effect by using each mutual fund's actual average allocation to 7 asset classes during the 3 years and applying these to passive index returns. The difference between the fund's actual performance and this passive return is the Selection effect. The 7 asset classes are U.S. Stocks, Foreign Stocks, U.S. Bonds, Foreign Bonds, Real Estate, Cash and Other. Then we also measure an "Allocation effect" as the difference between the return on this passive implementation of the fund's actual allocation and our benchmark's return, since our benchmark is almost entirely passively managed. This Allocation effect is driven by differences between the mutual fund's allocations along segments of the glide path and the corresponding allocations of the TDA Index.

These allocation differences create a *yin and yang* for performance. Allocating more to equities than our index benefits performance during these 3 years because equities

outperformed bonds. By contrast, holding less diversifying assets, like foreign securities and real estate, undermines performance. Accordingly, we further break out the Allocation effect into Aggression and Concentration. Aggression measures the value added or subtracted through more or less equity exposure than our index, and Concentration measures the performance effects of not diversifying as much as our index. The Aggression effects in the previous exhibit are clear to see in the next exhibit. Aggression in the previous exhibit is positive for Current funds and 2040 funds, when average mutual fund equity allocations exceed our index, and Aggression is near zero for 2020 funds when average equity allocation approximately matches our index.

Details of Aggressiveness



Unlike Aggression, Selection and Concentration scores for the past 3 years are generally negative across all target dates, indicating that passive implementation of the actual asset mix would have served investors better, as would broader diversification.

<u>Conclusion</u>

In summary, our Safe Landing Glide Path tends to have lower equity allocations than most target date funds in early years, when the horizon to target date is long, and also in later years, as the target date nears. In between these two extremes, the indexes' equity allocations are near those of the average target date mutual fund. However, our indexes' allocations are at all times substantially more diversified than most target date mutual funds. These characteristics are offsetting. The broad diversification of our glide path makes them hard to beat in most markets. However, the returns for Current and long-dated funds become easier to beat in rising equity markets. Of course, this tendency reverses in weak or falling equity markets. (For example, there were a total of 50 Current and 2010 Target funds with one-year performance as of 12/31/2007. 49 of them underperformed the Safe Landing Glide Path, by over 330 bps on average).

In other words, mutual funds tend to use different glide paths than our Safe Landing Glide Path. Please see the TDS Website for the rationale underlying our benchmark glide path. It's based on solid logic including Probability of Loss Theory and Liability-Driven Investing (LDI). We expect our indexes to be difficult to beat in most market environments, setting the standard for the future.

On the security selection front we find persistently negative scores, indicating value subtracted by active management across the board. This persistence is even more pronounced than the tendency for active single asset class managers to underperform their benchmarks. The promise of enhanced performance through active management is not being delivered upon by most target date funds.

Investor concerns about these relatively new offerings are justified, but we believe that things will only get better.