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TARGET-DATE STORY

To Retirement and Beyond

*By Halvard Kvaale, Barbara Reinhard, CFA®,
and Amit Sinha*



INVESTMENTS & WEALTH INSTITUTE®

TARGET-DATE STORY

To Retirement and Beyond

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Over the past decade, we have seen widespread adoption of target-date funds (TDFs). Fiduciaries and investors alike value the ability of TDFs to simplify retirement investing by offering a comprehensive retirement solution in a single fund allocation. Despite this inherent simplicity, there is a misconception that TDFs are cookie-cutter solutions and offer simplistic investment approaches. In reality, the universe of TDF solutions offers divergent and, in many cases, sophisticated investment methodologies across three key aspects of design: glide path (i.e., how the equity and bond allocations change over time), asset allocation, and underlying managers. In this article, we discuss how taking a simplistic approach to these aspects of TDFs can lead to suboptimal results. We examine best practices when it comes to target-date design to achieve the following:

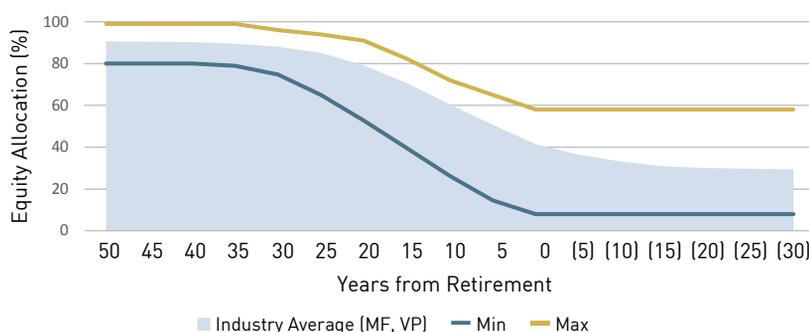
- Investor-focused glide path to maximize an individual's dual objective: maintain standard of living without running out of assets
- Asset allocation that is broadly diversified and adjusts to market conditions and a person's time to retirement
- Underlying manager mix that adjusts over time to shift from better upside capture tilt to better downside capture tilt

GLIDE PATH DESIGN

The TDF industry currently employs a wide range of glide paths and, subsequently, a wide range of returns. In

Figure 1

MEANINGFUL DIFFERENCES IN EQUITY ALLOCATIONS AMONG TDF MANAGERS



Source: Morningstar Direct as of December 31, 2019. Industry average reflects stock weights for mutual fund and variable annuity providers. Equity allocations based on Years to Target Stock glide path data in Morningstar Direct. This data may differ from Morningstar analyst reports, which combine Stock and Other. Exclusions include Invesco Balanced-Risk Retirement Series, Fidelity Simplicity RMD, and Fidelity Managed Retirement.

figure 1, the range in equity allocations across the most aggressive and conservative glide paths is a staggering 50 percent for investors five years from retirement.

All glide paths in the industry have the same overall concept—i.e., every TDF will glide down over time—exposing young investors to a high percentage of equity (the accumulation phase) and then systematically reducing equity over time as these investors progress through their life cycle. The rationale for this approach can be explained by considering investors' two sources of wealth: labor income (salary and wages) and 401(k) retirement account balances.

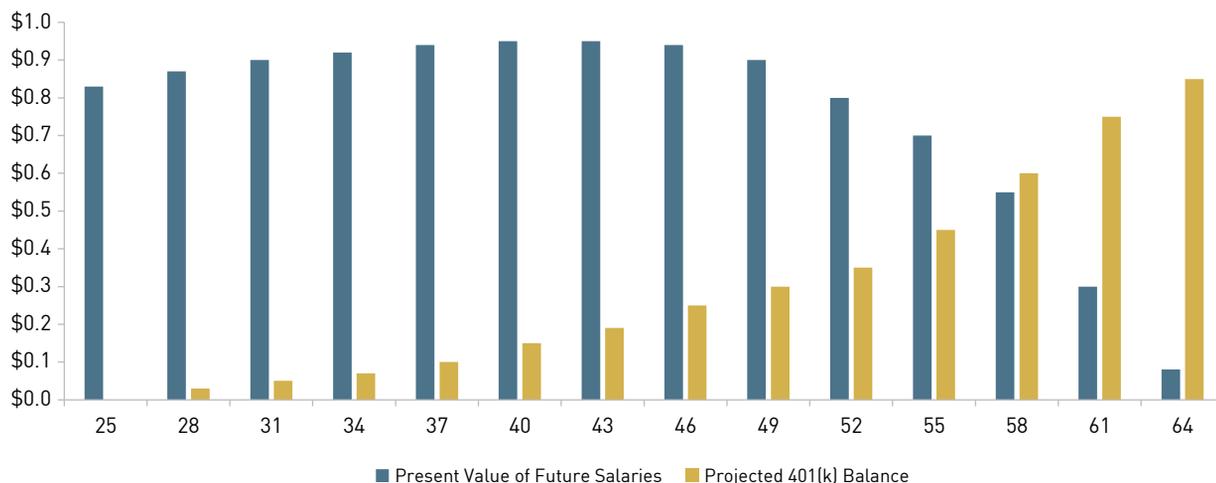
As figure 2 shows, the amount of wealth generated from these two sources—labor income and retirement account balance—shifts over time. During the accumulation phase, in addition to the

investor's long investment horizon that affords greater ability to withstand portfolio volatility, the present value of labor income exhibits bond-like characteristics that allow steady contributions through market downturns, which helps investors add to their holdings at a deep discount. Finally, investor account balances at this stage tend to be low, so losses are limited. For these reasons, it is appropriate for the glide path to have aggressive (high) equity allocations at the onset of an investor's career to help maximize expected return at a time when investors are well-positioned to withstand expected market volatility.

As retirement approaches, the present value of an investor's labor income rapidly declines on both an absolute basis and relative to the investor's projected retirement account balance. At retirement, income is discontinued, and the retirement account balance becomes the

Figure
2

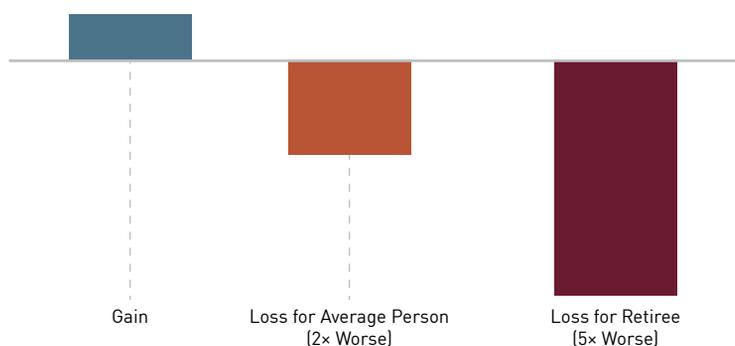
THE TWO SOURCES OF RETIREMENT FUNDING SHIFT OVER TIME, HYPOTHETICAL EXAMPLE



Source: Voya IM

Figure
3

THE AVERAGE PERSON WEIGHS A LOSS TWICE AS MUCH AS A GAIN, BUT RETIREES TEND TO WEIGHT LOSSES FIVE TIMES MORE



Source: AARP, American Council of Life Insurers

investor's primary source of wealth. During these later years, the investor is far more vulnerable to market downturns. The ability to counter portfolio losses with future contributions is greatly limited because remaining future income is small relative to the size of the retirement portfolio. These circumstances warrant a rapid decline in equity allocations as retirement nears.

From here, the question arises: What are the primary differences between glide paths?

Differences between glide paths are driven by assumptions and philosophies of the target-date manager. A distinguishing characteristic of a glide path

is whether the TDF is managing "to" retirement or "through" retirement.

"Through" glide paths typically are characterized as having greater allocation to equities near and at retirement in order to mitigate longevity risk, i.e., the risk that the investor will outlive the assets. A major assumption for these offerings is that investors will stay within the TDF past retirement, so they can ride out market volatility to enjoy gains from a greater exposure to risk assets. As the investor retires, the target date will continue to glide down, selling down equities for fixed income. A "through" approach also ignores the loss of the participant's access to labor income, which is unavailable to counter any portfolio losses.

On the other hand, a "to" glide path approach recognizes that a participant's greatest sensitivity to market risk is at the end of a career, and therefore it typically has a lower allocation to equities at retirement. A "to" glide path seeks to protect near-retirement portfolios from large losses, thereby limiting shortfall risk within retirement.

Primary reasons "to" managers cite for their conservative positioning heading into and at retirement are the following:

1. At retirement, sequence-of-return risk is highest for an investor. Any significant market downturn in the early years of retirement has a far greater impact on the longevity of assets than at any other time in an investor's retirement. A "to" glide path has a double hedge against this risk through its conservative positioning and by not selling into any drawdowns in retirement as "through" managers will have to do systematically.
2. Loss aversion, a key tenet of behavioral finance, is heightened five-fold at retirement, because at this point, account balances are likely at their highest levels and market volatility would mean sizable absolute dollar losses. As a result, investors are more susceptible to selling at market bottoms, depriving themselves of

the potential to recoup losses over time (see figure 3).

ASSET ALLOCATION

Effective target-date portfolio management goes beyond determining the optimal equity and bond mix over an investor's life cycle. Determining which sub-asset classes to use in order to implement the equity and bond mix is equally important. Accordingly, sub-asset class breadth and how the sub-asset classes are adjusted to manage the various risks that an investor faces also are critical for fiduciaries to understand and evaluate. Similar to glide path design, target-date managers diverge significantly from one another when it comes to asset allocation. Breadth of exposure can vary by 10 or more asset classes; some managers invest in as few as five dedicated asset classes, and others access more than 15.

Moving past the well-known benefits of asset class diversification in a retirement portfolio (improving risk-adjusted returns over the long term), differentiating the sub-asset class allocation across an investor's life cycle also can lead to increased alignment with an individual's retirement objective. TDFs must adapt to the evolving risks investors face as they work, save, and retire. In order to optimize asset allocation throughout the investor's investment journey, fiduciaries should be aware how sub-asset class diversification adjusts to manage these life-cycle risks.

Some target-date approaches take a static approach to asset allocation,

where sub-asset class allocations within equity and bonds remain proportionally static throughout the entire glide path. For example, the percentage allocation to emerging market equities may remain at 10 percent of total equities in both the 2020 vintage and 2050 vintage.

On the other hand, there are life-cycle focused target-date approaches that take a dynamic approach and actively adjust the sub-asset class allocations over the life cycle. We believe this approach provides an additional lever that a target-date manager can use to prepare the investor for retirement.

WHAT'S THE ADVANTAGE OF A DYNAMIC APPROACH?

In the glide path design section above, we discussed how early career investors have the risk capacity to withstand and benefit from portfolio volatility, leading to a higher equity exposure in target-date vintages that are further from retirement. Correspondingly, risk capacity in early years can be used for sub-asset allocation, by investing a greater proportion of the equity allocation in higher-beta asset classes, such as U.S. small-cap and emerging-market equities, to take advantage of their

potential for greater returns, given a sufficiently long investment horizon (see table 1).

As investors move closer to retirement, the need to preserve wealth takes precedence and can be articulated in the glide path and in the sub-asset allocation. Dynamically shifting to less-volatile, lower-beta, and lower-currency risk asset classes within equities, such as U.S. large cap, and simultaneously emphasizing income-producing assets such as high yield bonds and other credit, has the effect of lowering overall portfolio risk while generating income (see table 2). In addition, closer to retirement, many TDFs look to increase allocation to asset classes that have a positive sensitivity to inflation to ease purchasing-power erosion for investors close to retirement.

UNDERLYING MANAGER APPROACH

Once the asset allocation is established, TDFs tend to invest in funds within each asset class and sub-asset class in order to obtain the desired exposure. The objective at this stage of portfolio construction is to select funds that meet or outperform their respective asset class

Table 1 **MAXIMIZING RETURNS IN THE ACCUMULATION PHASE: BROADER EXPOSURE TO EQUITY ASSET CLASSES DELIVERS POTENTIAL OUTPERFORMANCE**

10-Year Risk and Return Forecasts

	U.S. Large Cap	U.S. Small Cap	Emerging Market
Return	5.8%	7.1%	8.3%
Risk	16.2%	22.7%	27.1%

Source: Voya Investment Management's 2020 Capital Market Forecasts. U.S. large cap = S&P 500 Index, U.S. small cap = Russell 2000 index, emerging market = MSCI EM index.

Table 2 **DYNAMIC ASSET ALLOCATION DESIGNED TO HELP PRESERVE WEALTH AS PARTICIPANTS APPROACH RETIREMENT**

	2060	2055	2050	2045	2040	2035	2030	2025	2020	Income
Equity % in Lower Beta	54%	55%	55%	55%	55%	56%	56%	59%	68%	67%
Equity % in Higher Beta	11%	11%	11%	11%	11%	10%	10%	10%	7%	6%
Portfolio % in positive, inflation-sensitive asset classes	3%	2%	2%	2%	2%	8%	8%	9%	9%	11%

Note: Beta is a measure of a stock's risk compared to the market. A stock with higher beta is riskier than the market; a stock with lower beta is less risky than the market.

Source: Voya Target Solution Trusts as of December 31, 2019

benchmarks. Within this final construct, we examine the ways in which portfolio construction can be another tool used by the manager to improve retirement outcomes for the investor.

MULTI-MANAGER VS. CLOSED ARCHITECTURE

Certain target-date managers are limited to selecting underlying funds solely from their own firms. This single-manager approach has the general benefit of favorable pricing and potentially increased collaboration with, and access to, the underlying managers.

Multi-manager target-date programs do not face the same restriction—they are free to select their preferred managers, thereby achieving greater diversification of manager styles and increasing access to asset classes beyond what a single investment platform can offer. Another key advantage is that multi-manager TDFs can utilize more than a single manager per asset class. This is a powerful tool within the portfolio construction phase, because the manager has the ability to adjust the mix of funds to match the changing risk and objectives across the glide path.

For investors nearing retirement, where protecting assets is a priority, a multi-manager program has the ability to shift a higher allocation to underlying managers that offer better downside capture ratios (i.e., ability to outperform the benchmark during periods when the benchmark is down). Conversely, for investors who have many years left before retirement and have the capacity to accept higher volatility for higher returns, the multi-manager target-date program can allocate to underlying managers that have demonstrated greater upside capture historically.

ACTIVE VS. PASSIVE VS. BLEND

Another key aspect of portfolio construction is the decision to allocate to actively managed strategies versus passive. Although the vast majority of TDFs invest in mostly active or mostly passive,

the best practice in the defined benefit and defined contribution world is to blend the two. Blending offers a cost-effective solution that allocates to passive in highly efficient asset classes without sacrificing (1) diversification because certain asset classes are difficult and/or costly to replicate passively or (2) alpha potential in less-efficient asset classes where the average manager has demonstrated the ability to outperform the benchmark over time.

We believe best practices when allocating to both styles involve taking multiple factors into account including the asset class, the market environment, and an investor's proximity to retirement. Key questions to consider include the following:

Alpha opportunity set within asset classes. How has the active manager performed historically relative to a passive alternative net of fees? Do certain market environments favor active versus passive managers?

Up/down capture management across the glide path. Do active or passive managers tend to provide better upside or downside capture ratios in certain asset classes and, if so, how can we take advantage of that within different target date vintages?

Liquidity management. Does the active or passive vehicle offer enough liquidity?

Fee constraints. What are the overall fee constraints of the target-date suite?

Availability and effectiveness of passive replication strategies. How effective is the passive vehicle at replicating the benchmark returns (high or low tracking error?) and at what cost?

Credit exposure management in fixed income. How effective are fixed income managers at adjusting their credit exposure throughout the business cycle? This takes into account that many active core

fixed income managers tend to outperform a passive alternative during an economic expansion but underperform particularly in the initial stages of an economic contraction because they tend to hold onto credit for too long.

PORTFOLIO CONSTRUCTION—PUTTING IT ALL TOGETHER

Each of the three key aspects of target-date design discussed above are independent processes that result in uncorrelated return streams. The complexity of constructing a suite of portfolios to satisfy the constraints of the glide path, strategic asset allocation, and manager (or index) choices simultaneously requires skill, experience, and a unique toolkit. As a result, a separate and distinct portfolio construction team with final oversight over the target-date suite is a critical component of managing a sophisticated TDF with multiple levers at its disposal. The portfolio construction team must have a comprehensive understanding of the characteristics of each asset class and underlying managers to fully evaluate the evolving risks facing the participant over the life cycle.

BEYOND THE ACCUMULATION PHASE

Historically, TDFs have been utilized primarily as an accumulation vehicle designed to help investors throughout their careers to arrive successfully at retirement. However, given the dramatic shifts taking place within the retirement landscape, with fewer employees that have access to a defined benefit pension plan, longer life expectancies, and lower interest rates, there is a critical and growing need to incorporate retirement income within a TDF. By doing so, investors have the opportunity to convert their savings into income without the complexity of having to do it themselves.

However, designing an optimal solution can be challenging and involves deep analysis of the trade-offs between the three main objectives of in-retirement investing:

- Providing attractive and stable cash flows (a “paycheck”) for a minimum fixed post-retirement period (e.g., 20 years)
- Providing an ending balance (after a 20-year period) for emergency, legacy, or longevity purposes
- Providing a level of predictability for the “paycheck” and ending balance

Achieving all three objectives (e.g., a high paycheck, high ending balance, and high predictability) is not feasible. To address this challenge, the industry has proposed a wide range of retirement-income solutions that range from guaranteed solutions to market-based solutions and include hybrid solutions that combine the two. Ultimately, successful solutions will need a combination of four key factors—ability to identify the appropriate trade-offs, ability to produce a consistent paycheck, guidance to help investors select the right withdrawal strategy, and finally, a mechanism to generate the paycheck.

CONCLUSION

TDFs have served investors well by allowing them to stay on track to meet their retirement goals through a well-diversified portfolio and helping them overcome key behavioral obstacles to a secure retirement. However, the misconception that TDFs are alike and employ simplistic investment approaches continues to persist.

The reality is that the implementation of target-date design can differ widely among managers and can incorporate sophisticated investment approaches within the glide path, asset allocation, and manager composition, as well as retirement-income approaches that are impossible for individuals to replicate themselves. Early TDFs were variations of the typical balanced fund, but many TDFs today bring the best of institutional portfolio management within the reach of individuals, helping solve one of the most complex financial problems in a single portfolio allocation. As the target-date space continues to evolve,

we expect further enhancements within TDF design, particularly during the critical spend-down phase in retirement. ●

Halvard Kvaale is head of manager research and selection for Multi-Asset Strategies and Solutions at Voya Investment Management. He earned an MS in general business from the Norwegian School of Management and an MS in investing from San Francisco State University.

Barbara Reinhard, CFA®, is the head of asset allocation for Multi-Asset Strategies and Solutions at Voya Investment Management. She earned a BA in economics from Trinity College.

Amit Sinha is senior vice president, head of multi-asset design for Multi-Asset Strategies and Solutions at Voya Investment Management. He earned a BA in business and systems modeling from Franklin and Marshall College.

Contact the authors at kristopher.kagel@voya.com.

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INVESTMENTS & WEALTH INSTITUTE®

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org

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