Finding the target (date fund)

Ryan Kuruliak | May 25, 2011

Target date funds (also known as lifecycle or age-based funds) have been available to Canadian capital accumulation plan (CAP) sponsors for about half a decade and are becoming an increasingly popular investment option for plan members.

Target date funds are a one-stop diversified investment product designed to make investing for retirement less complicated. They go beyond the traditional balanced fund, using a multi-asset class approach that adjusts the asset mix according to the plan member's investment time horizon or target retirement date. A target date fund provides a member with a diversified single investment option that dynamically adjusts the asset mix over time *without any action from the member.*

Given the well documented behavioural characteristics of many CAP members (lack of investment knowledge, naive diversification, inertia, regret avoidance and apathy towards investment decisions), most plan sponsors would agree that there is a place for target date funds within CAP investment structures.

It should be of little surprise that after a target date fund family is introduced in a CAP, the funds often become the preferred choice for many members. We have seen implementations of target date funds in plans where the eventual take-up by members has been above 80%, even though members were offered the traditional 'a-la-carte' menu of asset class funds (Canadian equity, foreign equity, bonds, et cetera) and more traditional balanced funds.

In my experience, target date funds see the highest usage at times when all members are required to make an investment decision (i.e. when a plan is changing carriers or when there is a mandatory re-enrollment).

In cases where target date funds are simply added to an existing fund menu, regardless of the amount of publicity and education provided, actual take-up by existing plan members is often low due to the earlier stated behavioural factors. However, even in these cases, usage of the target date funds by new plan members will often be quite high.

Given that these funds will likely form the backbone of many members' retirement investments, it is imperative that plan sponsors understand the key differences among the target date fund options available and that they introduce a fund family that is appropriate for their members. While there are many factors to consider, and many differences in the products currently offered, the most logical place to begin due diligence is to understand the glide path structure of the different fund families.

Glide path structure

The target date fund's asset allocation track, through time, is often referred to as the fund's glide path. Studies have shown that asset allocation differences explain the majority of an investor's variance of returns (**Brinson, Hood and Beebower 1986**) and performance (**Ibbotson and Kaplan,**

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2000). However, while it is generally agreed that asset mix is a key driver of successful investment outcomes, it is also equally clear that the target date fund providers do not agree on an appropriate asset mix for a given age. This can be illustrated by looking at the range of equity allocations of the funds at opposite ends of the target date spectrum—those designed for individuals in (or near) retirement and those designed for young plan members.

	Retirement Fund	2040 Fund
Fund Family A	40%	100%
Fund Family C	20%	45%

Retirement funds have an equity weighting as low as 20% and as high as 40%, with more examples closer to the high end of the scale than the low. Clearly, there is a wide gap among the providers shown here, one that could have a profound impact on members and retirees.

Funds designed for the younger cohort of plan members (20+ years to retirement) also have a wide spectrum of risk characteristics. The equity weighting from one provider is 100%, and the low weighting is 45%, again with more examples near the top of this range. It is clear that when it comes to the key driver of returns over the long run, (asset mix/glide path), there are key differences in philosophy, design and ultimately, potential account balances of members.

The above two points examined the asset mix at a point in time, but glide paths also encompass the asset mix *though* time. Some fund families utilize a simple investment heuristic, such as 100 minus a person's age should equal the target weight for equities. This approach, while easy to understand and execute, often leads to asset mixes that are too conservative too early in life.

Other fund families incorporate the concept of human capital into the glide path. In these cases, asset mix is driven by the average member's present value of future earnings (human capital). A young member's assets would be mostly in the form of human capital (versus financial capital), while the assets of a person close to retirement are dominated by financial capital. Approaches that take into account human capital concepts will typically lead to a higher weighting in equity in the early- to mid-career stages.

Risk tolerance

One knock against many target date fund families is that they do not account for an investor's risk profile when determining the appropriate asset mix. They assume all members in the same age class should hold the same investment mix. Some more recent funds offer the ability to choose a fund that not only matches the member's time horizon, but incorporates the individual's conservative, moderate or aggressive risk tolerance.

This can be an attractive concept, given that risk tolerance is dependent on factors other than age. However, this approach does add a wrinkle into what was supposed to be simple investment decision, "I know when I will need the money, I know what fund I should be in."

With these fund families, members will need to determine their risk tolerance and revise it if their situation changes. However, it has been observed that setting and revising risk tolerance is rarely practiced by members utilizing the more traditional 'a-la-carte' options. Many of members utilizing target date funds are often presumed to be the least engaged members in the plan, meaning they may be even less likely to perform the above noted actions.

The right path

Depending on the size of your CAP program and the carrier providing recordkeeping services, you may be limited to only one target date fund family. Other providers provide access to multiple products and some large sponsors, not satisfied with the off-the-shelf solutions have decided to create their own target date funds. Regardless of the situation, the fiduciaries of the plan need to be satisfied that the fund family's glide path is both understood and appropriate for the members of the plan.

Glide paths are certainly an extremely important component of each target date fund family and there are very important differences among the available choices. However, the glide path is not the only important factor for a plan sponsor to consider.

Plan sponsors should also examine the method the funds use to execute the glide path, and research the number and types of asset classes in the funds, the investment style of the underlying managers, the return and risk characteristics of the fund performance and of course, the fee structure.

A closer examination of these, and other, issues will the topic of a future article.

Ryan Kuruliak is a Toronto-based vice-president with Proteus Performance Management Inc. He has more than 13 years experience in the pension and investment consulting industry.
These are the views of the author and not necessarily that of Benefits Canada.

Part 2: Finding the target (date fund)

Ryan Kuruliak | July 8, 2011

My previous article, **Finding the target (date fund),** introduced target date funds (TDFs)—also known as lifecycle or age-based funds—and provided background for why they are becoming an increasingly popular choice for capital accumulation plan (CAP) sponsors and their plan members.

TDF usage by members will often be very high, and plan sponsors should ensure that the TDF family they're offering is appropriate for their membership. This is especially important as new products are launched, many with new, key differentiating features. As discussed in detail in Part 1, the TDF's glide path, or asset mix through time, will be a key differentiator between products, but plan sponsors should also evaluate many other aspects as part of the due diligence process.

Glide path implementation

Not only is the point-of-time and through-time asset mix important but also the evaluation of other aspects of *how* the glide path is implemented. Plan sponsors, then, need to consider the following questions:

- Is the glide path managed *to* the retirement date or *through* the retirement date?
- Does the fund use active or passive management, or a mix of both where optimal?
- Does the fund employ "best-of-breed" specialty investment management, or can one manager deliver the required performance in all asset classes?
- Is there a tactical asset mix overlay to the glide path (i.e., does it try to add value over time)?
- Will the asset mix and fund composition evolve over time and who will make these decisions?
- Does the fund family offer multiple risk tracks (i.e., conservative, moderate and aggressive) versus the one-size-fits-all approach?
- Can you tweak the asset mix later in the life of the fund, based on the plan member's financial situation?
- Does the retirement fund include a real return component?

Product asset classes

Many of the first fund families used only the basic asset classes—cash, bonds and domestic and foreign equities. As more products have come to the Canadian market, providers continue to expand the types and flavours of asset classes in their products. Examples include LDI-oriented bond allocations, low volatility equities and alternative asset classes. When evaluating a fund, then, plan sponsors should explore the following:

- What asset classes are offered? Do these assets provide adequate diversification?
- Do you use, or are you comfortable with offering, alternative investments?
- Are the asset classes liquid? What are the possible implications if they are not?
- How do you manage your fixed income exposure? Does it make sense for your members?
- Do your equity asset classes have a strong style bias (value/growth), and is this consistent with your plan philosophy?
- What is your foreign equity exposure, and is it appropriate?
- How do you handle currency hedging, if you handle it at all?

TDF performance

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Over the long term, TDF performance will be judged in relation to the plan sponsor's ability to deliver successful retirement outcomes for members. Unfortunately, most fund families have been available only for a short time, and long performance track records are simply not available. As well, the usual caveat applies: past performance may not be indicative of future performance. Having said that, plan sponsors should still consider the following:

- Did the funds perform as you expected through the recent difficult markets and the rebound?
- If you were approaching retirement or in retirement, would you have been happy with the performance of the short-dated or retirement TDF?
- Do you have a built-in performance guarantee? What is the real cost to members (in the form of either additional fees or lost upside potential)?

Investment management fees

As with all investment products offered in a CAP, plan sponsors need to evaluate the appropriateness of the fees charged. TDFs have some unique aspects in this regard, and plan sponsors should ask the following:

- Generally, are the fees appropriate?
- Are the fees materially different than a balanced fund or a do-it-yourself TDF? Can you justify the increased fees?
- Do the fees decrease as the fund gets more conservative, holding more and more lower-cost bonds and cash?

In the U.S., where the target date market has had more time to develop, structures have been created that allow plan sponsors to customize the glide path and, in some cases, even change the underlying funds and managers used in the program. While not for everyone, plan sponsors that *are* comfortable with this level of management or those that can access outside expertise may find that these structures can allow for the customization not available through "off-the-shelf" products. This approach has the added benefit of leveraging the lower fees and governance structure for the funds already offered in the plan.

Beyond the product features, plan sponsors should ensure that their recordkeeper be able to provide reports on how many members are in the funds, if these members are using the TDF options in conjunction with other à la carte funds, and be able to provide *CAP Guidelines*-compliant reporting and education materials on an ongoing basis for members.

As these two articles have illustrated, introducing a TDF into a CAP is not as simple as picking the fund with the best performance or lowest fees. Both performance and fees are important, but so are many other features that, over the long term, can have material impact on member outcomes. Plan sponsors need to evaluate and understand the implications of the various design features and be comfortable that, on balance, they are appropriate for the plan membership.

Ryan Kuruliak is a Toronto-based vice-president with Proteus Performance Management Inc. He has more than 13 years experience in the pension and investment consulting industry.
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