A Primer on Target Date Funds

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Over the last decade, the growth in retirement plan assets managed via target date funds (TDFs) has developed into one of the most powerful trends in all of financial services. A large percentage of these assets are invested through the various defined contribution structures such as 401(k), 403(b), and 457(b) plans.

Below, we explore the history, structure, and role of target date funds in retirement savings plans.

HISTORY OF TARGET DATE FUNDS

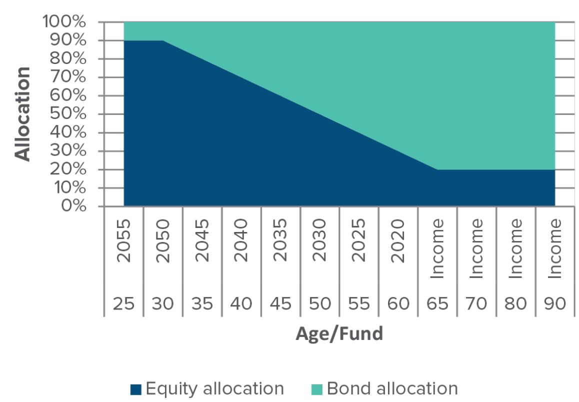
As the retirement landscape continues its glacial shift from a defined benefit environment to a defined contribution structure, investor education and financial literacy have become increasingly important. However, plan sponsors often find that efforts to improve financial literacy and participant education have limited effectiveness.

It has been said that "complexity breeds inertia." As it relates to investments, offering too many options, while well-intentioned, often confuses individual investors. Thus, in the early 1990s, the original target date funds were designed to fill this void with a simplified "set it and forget it" solution in a single investment option.

DESIGN

The general structure of TDFs involves the following principles and goals:

- Grouping individual investors into age-specific bands as a surrogate for risk tolerance (i.e., younger investors are considered more aggressive and older investors are considered more risk-averse)
- Equating an anticipated retirement date with the "target date" of the underlying fund (e.g., a 35-year old is expected to retire in 30 years, so they are grouped into the "2045 fund")
- Designing funds that automatically shift the asset allocation from "accumulation/growth" (heavier in equities/stocks) to "capital preservation/distribution" (heavier in bonds/fixed income) as investors approach and enter retirement
- Reducing the volatility/risk associated with equity investments as investors approach retirement, while increasing the allocation to fixed income/bonds. This glide path automatically reallocates assets from "equity allocation" to "bond allocation" as participants move closer to their retirement date. See Exhibit 1 below:



- Designing a risk-appropriate, diversified allocation for the years "to and through" retirement

When utilized appropriately, TDFs can mitigate the impact of poor investment choices made by individual investors during times of market volatility by reducing an investor's tendency to make emotional, financially-irrational investment decisions and keeping investors on a steady, pre-determined glide path as they approach/enter retirement.

GROWTH OF THE CATEGORY

As investors have grown familiar with the role and benefits of TDFs over the last ten years, assets have grown from $116 billion to $763 billion, according to Morningstar.

IMPORTANT LEGAL TOPICS

- The Pension Protection Act of 2006 (PPA) contributed to the consistent growth of TDFs by making them one of three strategies allowed as a Qualified Designated Investment Alternative (QDIA). (See www.dol.gov for the Department of Labor's discussion of the QDIA provision.)
- The PPA provides the framework for auto-enrollment and auto-escalation, along with the QDIA features and relief from liability for plan fiduciaries.

ADDITIONAL QUESTIONS AND TOPICS TO REVIEW

- Effective performance measurement & benchmarking is still evolving for TDFs; to address this challenge, Cammack Retirement has developed a proprietary framework that groups available funds into six categories based on their underlying glide path and portfolio construction techniques.
- Risk tolerance: risk is often measured by a fund's volatility (or standard deviation), but for TDFs, risk is also associated with the fund's overall allocation to equity investments (stocks)
- Longevity risk: the risk that an individual investor may outlive their income/assets
- If an individual investor chooses to invest in a target date fund, but wants to make their portfolio either more or less aggressive, they have two options: supplement their age-associated target date fund with a separate equity/or bond fund(s) or invest in a different age-group fund. To invest more aggressively, a participant would invest in a longer-dated fund which should provide a higher equity allocation over time; to invest more conservatively, invest in a shorter-dated fund which should provided a higher fixed-income allocation.
- Investment vehicle: TDFs are offered via mutual funds or collective investment trusts. This decision would be made at the plan level; thus, individual investors should not be concerned with the distinction.

CONCLUSION

Target date funds have experienced increasing popularity and growth in recent years, becoming an important option in many defined contribution retirement plans. For additional information or a more in-depth conversation on target date funds, please contact your Cammack Retirement Group consultant.

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Cammack Retirement Group is a leading provider of investment advisory, consulting and actuarial services. We work with the nation's leading healthcare providers, academic and research institutions, corporations, non-profit organizations and public sector employers to help them manage fiduciary risk.

For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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