TARGET-DATE DEBATE

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The Evolution of Target-Date Funds

The Great Target-Date Debate
Well diversified asset allocation strategies like target-date funds typically perform better than the average do-it-myself participant," says Susan Viston, client portfolio manager in the Multi-Asset Strategies & Solutions Group at ING U.S. Investment Management.

"There are a lot of behavioral finance issues at play. Inertia, over-concentration in specific managers or asset classes and buying high and selling low can all have a negative impact on participant results,"

In addition, according to ING’s research, target-date fund users were more confident overall than non-users about their ability to meet their retirement goals. They were also more engaged with their company’s retirement program, more likely to make higher contributions, and more likely to say they could convert their savings plan into an income stream at retirement.

"Because they are all-in-one investment vehicles, target-date funds are a great retirement plan solution," says Randall Lowry, managing director for investment product management at TIAA-CREF. "They are highly diversified across asset classes and investment styles. They span a multi-decade time horizon. They are suitable even for sophisticated investors. Most people don’t have the time or inclination to put together a portfolio, and manage it in a risk-adjusted way, and rebalance it over time. Plan sponsors often find themselves confronting that inertia." Yet, he says that participants’ inertia can work to their own benefit. "Plan sponsors can leverage inertia in a positive way so that participants are better prepared for retirement than they might otherwise be," says Lowry. "Whether that is through various auto features or guaranteed income options, or increasingly, by selecting the right target-date fund as a default investment option.

According to Morningstar’s most recent data, target-date fund assets broke the $500 billion mark in March 2013. While growth rates have fallen from their peak in the mid 2000s, when they were introduced, Morningstar’s 2013 Target-date Survey shows that on an organic basis “flows remain healthy and show signs of leveling off,” even as the market matures. According to Nathan Voris, large market practice leader in Morningstar Investment Management, “Research clearly shows that most people are not comfortable with investment decision-making and need help. So it’s completely rational that the bulk of retirement asset flows are going to products designed for that very purpose, to meet those investment needs.”

He says, "If you asked your neighbor what a target-date fund is, you probably wouldn’t get a great answer. But for most participants, if you can be confident that your default investment option is appropriate for you, whatever your age, you’re probably pretty relieved that you don’t have to do your own asset allocation and that you are still appropriately invested.” Voris argues that target-date funds can help lead to better outcomes not just from an investment perspective but also from a behavioral standpoint, by improving participants’ perception of how they are doing. "If you have more engaged participants and possibly higher savings rates, that could potentially add a lot of value," he says.

Yet, he adds that participants are often not making an active choice to invest in a target-date fund. Rather, they are simply accepting the fund that the sponsor has decided to include as the default investment within the defined contribution program which makes the plan sponsor’s decision all the more important.” Today, sponsors have an array of target-date options, from very aggressive to very conservative. It’s up to the consultant and plan sponsor to examine the options and decide which best fits their participants.

More Choice Means More Complexity for Plan Sponsors

“We clearly see a shift in the discussions that we are having with plan sponsors and consultants," says Brian M. Baskir, FIA, head of Global Consultant Relations for ING U.S. Investment Management. “Years ago, conversations focused mostly on what target-date is and why it is a good idea. The discussion has now shifted to a much higher level.”

While the bulk of target-date assets remain with a few large providers, competition is increasing and plan sponsors have more choices when it comes to both off-the-shelf and custom target-date options. According to Baskir, selecting a target-date fund has become a complex process that needs to address a wide range of issues, from participant communication to reporting and operational setup to fiduciary issues, fees, and product format.

“There’s a much deeper understanding and much more in-depth discussion today about key design choices,” he says. “In the decision-making process, plan sponsors need to devote the time to understanding the design choices that are appropriate for their particular employees.” He believes that the target-date manager, plan sponsor, and consultant need to be able to answer the questions, “What’s our overall philosophy and do we have actual experience to validate the approach we plan to follow?” He says that a single number will rarely demonstrate success or expertise, and it’s very important to have a clear rationale around supporting key design choices, whether that is open or closed architecture, active or passive, or an active/passive hybrid.

Glidepath models should be based on robust and ongoing research into participant behavior, whether for off-the-shelf or a custom fund. “With so many different flavors available, plan sponsors need to ensure that the selection process is well thought through,” says Baskir. “If they do, I’m sure that they can find a great match with a solution out there in the marketplace.”

Michael A. Rosenberg, executive vice president for Prudential Investments, and head of distribution for Investment Only Defined Contribution, agrees that plan sponsors have to consider a more complex set of factors than in the past: “They have to build their fund menu around the plan design, including
other benefit plans, participant demographics, such as risk profiles, savings rates, and levels of sophistication. And just as important is the company’s view of its own role in supporting not just retirement savings, but also participants’ overall retirement outcomes, including income security.”

According to Prudential’s research, nearly two-thirds of employers think a “significant portion” of employees will have to delay retirement because their savings are inadequate. That view is backed up by Prudential’s Retirement Engagement Research and National Retirement Risk Index, which found that 57 percent of Americans believe they can’t save enough for retirement and 54 percent of people risk having insufficient retirement savings.

In light of these numbers, Rosenberg believes that auto-enrollment, auto-escalation and other behavioral solutions are appropriate. “But that leaves open the question of how the money is invested to improve outcomes for participants. That is what target-date funds were designed to do.” While choosing a target-date fund has become more complex for plan sponsors, he says these funds must evolve still further.

The Next Generation of Target-date Funds

“They of us who have spent decades in this business have seen that the evolution of retirement investing theory tends to be slower than for non-retirement markets,” says Joan Bozek, senior vice president of Investment Products at Prudential Retirement. “But after the most recent recession, and as we are well into our second decade of experience with target-date funds, it’s clear that as portfolio theory evolves, retirement investing needs to evolve with it.”

Bozek points out that even while investors, plan sponsors, and fund providers in the retirement market tend to be conservative, many retirement fund complexes have moved into areas of non-traditional asset classes and non-traditional features, such as guaranteed income and payout options, either as standalone options or when folded into target-date funds.

“These changes are beginning to take hold, and we need to bring more of these innovative, defined benefit type approaches to the table,” says Bozek. She argues that a broad spectrum of offerings and well-diversified portfolios are important to meeting the fiduciary obligations of plan sponsors. “That could mean exploring non-traditional asset classes,” she says, “and look at how those asset classes fit into the different types of bundled target-date or target-risk funds. It could mean adding guaranteed income so participants feel secure in their investment choices even if they experience a market disruption in the years leading up to retirement.” She says that the same thinking applies to product design and construction. Non-traditional approaches should be explored, as many sponsors are doing with separately managed accounts, collective trust vehicles, and other institutional strategies. That kind of thinking can be woven into target-date funds as well.

“I think the needs and behaviors of the investing public are evolving, and target-date funds need to evolve, and will evolve to meet those needs,” says Bozek.

“Some of the divergence in the market has to do with managers trying to make their products unique,” says Jeremy Stempien, director of investments at Morningstar Investment Management. According to Stempien, a lot of the newer products “have wrinkles to them,” such as more conservative glidepaths or tactical overlays or the inclusion of exchange-
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Becoming Voya™ Investment Management in May 2014
A Roundtable Discussion of Issues in Target-Date Fund Design and Selection

As assets and choices continue to grow in the target-date space, fund selection is becoming an increasingly complex task for plan sponsors. The choice is also becoming increasingly important as more and more target-date funds are added to plans as the qualified default investment alternative (QDIA) option. On one hand, more choice is beneficial, as it provides more opportunity for plan sponsors to find funds that match their own philosophy and plan demographics. More choice, however, requires that a wide range of issues related to plan and fund design be examined, often with the help of a skilled consultant. This panel of target-date experts offers insight into the overall fund-selection process, as well as into issues of key design choices, and of how to measure the performance of whatever target-date fund a sponsor chooses to add to the plan menu.

P&I: First, let’s talk about ‘to’ versus ‘through.’ In a year when equity markets took off, target-date glidepaths with higher equity allocations—commonly the ‘through’ variety—did well. How should plan sponsors think about performance and other issues that go into the ‘to/through’ decision?

Nathan Voris: First off, in an up market ‘through’ managers will probably outperform and tout how great they are, and in a down market ‘to’ managers will do the same. To us it’s a lot of smoke and mirrors. We don’t believe a plan sponsor should choose a glidepath series based strictly on whether it’s the best or worst performing target-date series out there.

In a defined contribution setting, the goal is not to be the best performing series, it’s to help participants reach their goals: accumulating savings and generating retirement income. Which means putting them in an appropriate allocation so that they are able to hit those goals without too much risk of shortfall. Plan sponsors and plan participants should compare target-date performance relative to those expectations, not simply to a generic market or peer benchmark.

Now, with respect to the ‘to’ versus ‘through’ debate, we are agnostic, although our default view is that a ‘through’ glidepath is typically more appropriate. Many people tend to stay in their company’s retirement plan for a period of time post-retirement, and we believe that sponsors shouldn’t be leaving retired participants, who must balance longevity risk with other risks, in a perpetually static or overly conservative allocation. That said, until we take an in-depth look at a plan’s underlying demographics, we wouldn’t necessarily recommend one over the other.

Randall Lowry: Our preferred approach is a ‘through’ glidepath, based on actuarial studies of the U.S. population, running thousands of participant and market scenarios, and modeling mortality risk. Our conclusion was that target-date glidepaths need to continue to evolve after retirement. If you look at existing funds that are beyond their retirement target date (e.g., 2010 funds), many people are still contributing. It’s an example of the inertia behind a lot of participant behavior. At any time investors may leave the fund, but for those who remain, we believe strongly that the asset allocation needs to be actively managed as the person ages to ensure that the allocation remains age appropriate.

Frank Van Etten: In our view, a glidepath should always be designed to deliver a successful retirement outcome to the plan participants. That means taking into account in-retirement assumptions such as actuarial statistics, income replacement ratio needs, and inflation risks. In that sense I consider
each glidepath looking ‘through’ the retirement age. Traditionally the ‘to’ versus ‘through’ discussion has been focused on when the most conservative equity allocation is reached. We believe that point should be at the time that the participant doesn’t have labor income anymore. Our models take into account the labor income profile when allocating among asset classes, but once that income stream falls out of the equation, we believe that the equity/bond mix should be stable. That said, the sub-asset-class allocation, particularly within fixed income, may need to be reviewed in retirement.

With custom glidepaths we always aim to match the plan sponsor’s targets for their specific participant base. So in some cases we have modeled glidepaths that would be labeled ‘through,’ while our off-the-shelf product would be labeled ‘to.’ To us it is much more important to develop the appropriate investment strategy than try to take a hard stance on ‘to’ versus ‘through’ as those two things simply can’t always be reconciled.

Joan Bozek: I don’t believe anybody should be pigeonholed into a ‘to’ or ‘through’ glidepath decision. Sponsors need to evaluate the glidepath more carefully, its underlying exposures, its inflation protection, and what tools are being used to protect someone for the 30-plus years that they may need this money to last in retirement. So I’d like to circle back to the issue of longevity risk and income, because I don’t think those are separate issues.

Where a participant has the option of an income guarantee, attached to or embedded in the target-date fund, we believe in using what the industry might call a ‘to’ glidepath, meaning that the allocations stabilize at the target date. However the allocation to equity at that point is much higher than your traditional ‘to’ portfolios would have, which allows for capital appreciation ‘through’ retirement and the benefit of an income guarantee to protect against loss. Where no income option is available, we prefer a ‘through’ glidepath with higher equity allocations in the early years, and then a much steeper glidepath and a shift into fixed income investments at a more rapid pace around the retirement red zone which continues into retirement.

But again, plan sponsors need to do a full evaluation of each manager’s approach, from the steepness of the glidepath to the use of inflation protection assets to income options and equity allocations in retirement. All these features have to be in line with your plan demographics, independent of whether a fund is called ‘to’ or ‘through.’

P&I: Another interesting performance data point is that, among fully packaged target-date funds, there is very little difference between ‘open’ and ‘closed’ architecture. In fact, ‘closed architecture’ funds had a bit of an advantage in 2013. What issues should plan sponsors consider when choosing between open/closed funds?

Randall Lowry: There are pros and cons to each approach. From an investment perspective, as well as an administrative and cost perspective, we believe that closed architecture does offer tangible benefits. These target-date managers have immediate access to underlying portfolio management teams and their research analysts. For example, to the extent that our international developed market equity manager may hold a few emerging market names, we know where the overlaps are. We believe that this kind of holistic view can help target-date managers considerably in fine-tuning their risk controls.

In addition, we run our tactical and strategic allocation processes side by side, and while the primary determinant of relative performance is strategic, it’s very helpful on the continued on page 10
classes. In our view, the extra return from using active and passive managers—using passive managers in more efficient asset managers. You can also reduce costs by blending investment lineup. Beyond the benefits of using best-of-breed managers, open architecture in-house, you can take advantage of who the underlying manager is. Finally, I would add that cost is dependent on a lot of factors, including the mix of active and passive sleeves. The architecture, whether open or closed, is not the only determinant of higher or lower cost.

Nathan Voris: We are definitely in the camp of open architecture and feel that it incorporates best practices that the consulting community has been using for decades. We believe that having more best-of-breed choices, for example among asset managers and vehicles, is better for the sponsor. No consultant that we know of would build an entire investment menu from a single manager. From a fiduciary standpoint, a plan sponsor that has all its investments provided by one asset manager, even in a target-date fund, should make sure it can defend that decision. There are qualitative issues as well: with closed architecture funds, it’s very hard to fire yourself if one of your in-house managers is underperforming. Open architecture alleviates these issues by giving the target-date manager the ability to select the most appropriate asset classes and funds regardless of who the underlying manager is. Finally, I would add that cost is dependent on a lot of factors, including the mix of active and passive sleeves. The architecture, whether open or closed, is not the only determinant of higher or lower cost.

Frank Van Etten: Open architecture is consistent with the way most defined benefit and defined contribution plans construct their investment lineup. Beyond the benefits of using best-of-breed managers, open architecture increases manager diversification, reducing single manager risk. It can help overcome capacity issues. It also gives you more flexibility when adding new asset classes and more leverage in dealing with weak performers.

Now, there are potentially added costs when hiring outside managers. So we believe open target-date managers need a scalable platform with sizeable distribution capacity, which can enhance efficiency and help in negotiating lower fees with outside managers. You can also reduce costs by blending active and passive managers—using passive managers in more efficient asset classes. In our view, the extra return from hiring best-of-breed managers can offset the extra fees. So on a net basis we think it’s better for the participants to be in an open architecture structure.

Joan Bozek: Neither open nor closed will be right for everyone. It depends on the firm managing the target-date fund, as well as on the philosophy and objective of the plan sponsor. What does the sponsor hope to accomplish?

That said, issues like overlap of holdings and fund transparency can be avoided by having one firm manage the underlying assets. There are plenty of large, diversified firms that bring expertise across fundamental, quantitative and passive investing—certainly enough to manage the limited number of sleeves within a target-date structure.

Scale is important; smaller plans keen on simplicity and reluctant to be in the manager selection business, often gravitate toward fully packaged closed architecture solutions. Even in the mega-plan space, however, we have yet to see when the time, effort and expense put into ‘open architecture,’ and even into custom solutions, equate with a performance advantage. As we have seen, trying to evaluate and pick managers in an open architecture environment, across styles, organizational structures, and approaches to portfolio construction, can take a lot of time without yielding a better result.

The key is to determine what is appropriate for each plan based on the size of the plan assets, the sophistication of the investors, the savings rate, and the sophistication of the investment committee or the fiduciaries. Due diligence, regardless of product format, is critical. Who are the underlying managers? What are their capabilities and what is their track record? To ensure the most appropriate target-date fund selection, the same level of due diligence should apply to all the underlying components of a target-date fund, no matter whether it is open or closed.

P&I: Let’s take on the issue of cost as it was just raised, specifically in the choice between active and passive target-date series. In 2013, for the first time ever, fund flows into passive series outpaced flows into active series, and passive series have been growing faster for years. What issues are most relevant to the active/passive question?

Frank Van Etten: We recognize that different plan sponsors want different features within their target-date funds, so we offer passive and active. That said, we believe strongly that taking an either/or approach will end up in missed opportunities to add value for participants. Our recommended approach is to be selectively active, which means being active in areas where we think the underlying managers will outperform their peers and benchmark after fees, gaining alpha potential while
Gliding Toward Retirement

Behind the rise of custom target-date solutions

The Rise of Custom
Custom target-date solutions are increasingly adopted by firms looking to strengthen their retirement plans, and while the process is complex, the reasons behind this shift are simple: fiduciary support, glidepath fit, possible cost savings, and the search for better participant outcomes.

Quality Matters
Some plans build a custom target-date series because they think the quality of the proprietary funds in most off-the-shelf solutions don’t meet the high standards of the funds they selected for the core lineup. “These plans have spent a lot of money to build an optimal lineup for their participants,” says Jeremy Stempien, director of investments at Morningstar Investment Management, a division of Morningstar that builds retirement solutions for plan sponsors and providers. “Since they’ve already done their due-diligence on these funds, sponsors are confident that they have met all the fiduciary obligations and that these funds are aligned with their participants’ needs. Often, they may not have the same level of confidence with off-the-shelf target date funds.”

Glide Paths, Not Guesses
Another reason plans embrace custom target-date solutions is they think their employees aren’t well served by a one-size-fits-all glide path. A plan may have a fairly young, highly paid workforce that invests heavily in the stock market. Another plan may have an aging workforce with little retirement savings. Sponsors may struggle to find appropriate glide path matches among the dozens of off-the-shelf options.

“Here’s the true benefit of a custom solution,” explains Nathan Voris, large market practice leader with Morningstar Investment Management. “When we create a glide path, we look at a range of factors, from the plan demographics to the investment behavior of participants. An off-the-shelf target-date fund’s glide path reflects what the fund company believes is the best asset allocation at a given point in time for the ‘average’ investor. If you don’t fit that ‘average,’ then this path may not be effective.”

Keep a Lid on Costs
Here’s a fairly common scenario: A sponsor invests time and money on a quality fund lineup. They hope that once assets accumulate within these funds, they can take advantage of sliding fee schedules. Then, in order to meet QDIA requirements, they add an off-the-shelf target-date fund, almost as an afterthought. And employees are defaulted into an option outside the core lineup. Many plans opt to redirect those assets with a custom solution.

Tailored Plans for Every Finish Line
“Every plan has a different reason for choosing a custom target-date series,” Stempien says. “I believe the true success of a target-date fund is that it maximizes the participants’ chances of reaching their goals. A qualified custom target-date provider should be able to project out those outcomes and clearly articulate how the investment and glide path decisions—as well as the management and monitoring expertise—will get a plan’s participants over, and, in some cases, beyond the finish line.”

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keeping a lid on costs. On the active side, you can also potentially enhance diversification with a broader range of asset classes because some asset classes are difficult to replicate passively, such as emerging markets equity or high-yield bonds. What you find is that both active and blended active-passive target-date series tend to be more broadly diversified than funds that take a purely passive approach.

What’s also important to note is that there is no such thing as totally passive investing within target-date funds. Because even with passive options, you have to make active decisions about the glidepath design and asset allocation. That can lead to very different performance and risk profiles relative to what one might consider the average target-date manager. So it’s not just a discussion of active and passive. Fund selection takes place within a much broader context.

Joan Bozek: As with so many issues in target-date design, the best solution will depend on a range of questions than can be answered only by the plan sponsor. Certainly fees are very important to most plan sponsors, as most asset managers. So, while we are philosophically committed to the idea of adding value ‘through’ active management, we are cognizant of fee pressures and try to bring in active and quantitative strategies where we can add value and still manage the overall cost of the portfolio.

This is especially relevant for non-traditional assets like public and private real estate, private equity, and absolute return strategies. Increasingly such assets are used in target-date funds for tail risk hedging, inflation protection and a range of other applications. So, where possible, and where it fits with the plan sponsor’s objectives and needs, we are strong advocates for a diversified blend of active, passive and quant.

Nathan Voris: We’d agree that taking a rigid stance either way is not the right solution. You have to look at the value, not just the expense. What are you actually paying for? I go back to the consulting paradigm: if you line up the top consultants and give them a billion dollars to build an optimal defined contribution menu, it’s not going to be all passive. So there’s no rational reason why that decision framework shouldn’t extend to target-date funds. Now, active management in general is a very tough game, and after accounting for fees, many managers underperform. There are good active managers, however, and after fees they do a great job and add alpha. There are also some asset classes where, inherently, active tends to make more sense than passive, particularly the more esoteric asset classes.

So if we are given a menu of 20 options or a dozen target-date sleeves to allocate to, we’re going to do our analysis and due diligence and we’re going to allocate to the managers that we feel are most appropriate. If the active managers are good and they add value, we’re going to use them.

Randall Lowry: I think we all agree that the decision is not clear-cut, and for plan sponsors it often boils down to philosophy. Each approach has its advantages, and like many target-date providers we offer both. Obviously passive has a distinct price advantage, and because of the lower price, some sponsors may see passive as a safer ‘safe harbor.’ That is, a passive series is going to closely track the broader markets and may

EXHIBIT 1: Target-Date Funds: A Broad Range of Choices

Source: P&I Custom Media Group 2014
not raise fiduciary issues around manager or fund selection or cost.

Just as clearly, passive can create a significant strategic deficit, in that you cannot be nimble in responding to risk. For example, the issue of rising interest rates is important for fixed-income managers. Passive strategies cannot respond by moving into floating-rate banknotes or other interest rate hedges. Another example is that as the U.S. government has issued a significant amount of debt, the Barclays Aggregate, which is the index used by most passive target-date managers, has become very government heavy. If you are a passive target-date manager, you have to buy it ‘as is’, regardless of other risk-return factors, because that is your index.

Target-date funds are multi-asset class vehicles, and there are a lot of moving parts. Passive series minimize the number of moving parts, whereas active series have many more tools at their disposal to respond to risks and opportunities.

P&I: Combining all these features in the right way for each sponsor raises the issue of custom versus off-the-shelf funds. Custom target-date funds are getting a lot of press and plan sponsor attention. What do you see as the pros and cons of custom versus off-the-shelf options?

Frank Van Etten: In the custom space there are really two distinct groups. The primary driver, historically, has been plan sponsors looking for open architecture and trying to leverage their existing defined contribution or defined benefit managers. They want more control over the underlying managers, or potentially a custom fee structure or operational setup. Today, more and more plan sponsors are looking for a custom glidepath to fit their labor income profile, which is the most crucial driver of the glidepath model. For example, in certain sectors income is more correlated with financial markets. Some industries are more susceptible to shocks in labor growth, which can cause overall participant earnings to vary from year to year.

Now, once we start the modeling and optimization, we always have to ask ourselves whether a custom fund is really needed. In many cases, a participant profile is not as unusual as they may think and can easily be matched to an off-the-shelf glidepath.

Off-the-shelf glidepaths, though, are based on longer-term equilibrium assumptions, which rarely change. In a custom glidepath, if anything changes at the company, like its matching policy or plan demographics and contribution rates, or the freezing of a defined benefit plan, a custom glidepath can adapt. For some companies that’s a very valuable feature.

Joan Bozek: We offer both approaches, and each has its place. In a rush toward customization, however, we should not forget the very real benefits of packaged solutions, which are in high demand by smaller employers. There’s a scale feature in package target-date solutions that makes sense for many plans, and jumbos select them as well, primarily to reduce complexity in their platform, as well as for fiduciary reasons. Sponsors can maintain a high degree of vigilance over a single provider. Custom solutions can pose implementation and cost challenges, from networking fund-of-funds to actuarial analysis for glidepath design and asset-class and manager selection.

Today, plan sponsors find themselves facing this large product spectrum and working with their intermediaries and consultants to pick the spot where they belong. You can go from fully packaged, open or closed, all the way to a combination of custom sleeves with custom glidepaths. The real work for sponsors is in the open and custom space, so I think packaged target-dates will continue to play a big role in the market because they supply what many sponsors and participants want: simplicity on the front end and professionals managing the complexity on the back end.

Randall Lowry: We also offer both and I’d agree that both have a place. A lot of the difference seems to hinge on open-versus-closed architecture, and we covered some of those issues earlier. Off-the-shelf solutions are simpler and easier. I think when plan sponsors dig into their data, many find that they don’t need a custom glidepath; given the increasing sophistication of off-the-shelf solutions, they can often find a good fit with something already out there in the market.

There is also the fiduciary angle, which plan sponsors take very seriously. Some will wonder if they are taking on too much as a fiduciary to put in place a qualified default investment alternative option that is quite different from what everyone else is doing. Others will see it as part of their fiduciary obligation to put in place a solution that is very customized to their participant population. Those are critical philosophical questions that sponsors have to evaluate and answer for themselves.

Nathan Voris: From our perspective, there isn’t a typical user of custom target-date funds. They are all over the board and the choice largely has to do with plan sponsors leveraging the work that they and their consultants are doing in selecting funds and managers for their core defined contribution menu or defined benefit plan. To us, it makes no sense to do all that work and then just funnel the bulk of a plan’s qualified default investment alternative assets into a completely different fund.

The cost of fully custom target-dates is falling. Minimums are coming down. Plans with as little as $200 million in assets can...
find cost-efficient custom solutions. The operational challenges are quite manageable. In the asset management business we have been unitizing funds-of-funds and striking net asset values for decades; this is absolutely the same. The initial process may create additional work, but once the custom fund is live, and you’ve gone past those hurdles, the oversight burden can decline markedly. Many investment committees treat it just like any other fund in the menu.

With all the potential benefits, I believe that plans may not be fulfilling their fiduciary duty if they’re not at least exploring custom in some manner. That doesn’t mean they have to choose it, but I think they should all at least explore it.

**Nathan Voris:** Whether choosing custom or not, performance shouldn’t be the leading criterion. The first thing a sponsor should know, before even looking at performance, is what sort of target-date series you want and what’s appropriate. At that point, when you’ve got maybe three to five peers that all fit your need, then we think performance becomes a factor in distinguishing from among those similar series. When it comes to benchmarking, plan sponsors and participants need to understand when they should expect their target-date series to perform well, and when it may lag behind a little bit. Sponsors should also be doing detailed performance attributions that identify which underlying components are adding or detracting, whether it’s specific funds or managers or asset class allocations or how aggressive or conservative the glidepath is.

**Frank Van Etten:** Performance attribution is crucial, but it’s not about return alone. It’s about risk-adjusted return, particularly in the context of a successful retirement. We look at four separate performance categories: shorter-term active trades that take place in a portfolio; the performance of underlying managers compared to their benchmarks and peer group; performance of the longer-term asset allocation; and performance of the glidepath. By separating those, one can already see that each component is evaluated according to a different time horizon and metrics.

Glidepaths, in particular are difficult to benchmark. Here, in addition to examining performance in the context of the target-date manager’s objectives, it may also be helpful to study forward-looking simulations of different glidepaths to understand what is the expected distribution of income-replacement ratios and how it differs from peers—in order to judge the different risk/reward tradeoffs of different glidepaths over longer periods of time.

It really has to be a holistic view of all the different features and structures of a target-date series from the glidepath, to asset allocation and underlying managers, as well as overall fees.

**Randall Lowry:** Especially in the target-date space, performance also has to be measured against expectations. Sponsors need to ask themselves, is it doing what we thought it would when we selected it? Is it doing what it should be doing? Sponsors should focus on those questions, rather than just reacting to the latest swings in the market.

Certainly they can look at target-date performance versus a peer group, making sure it’s the right peer group. For example, ‘to’ funds should be compared with each other and not with ‘through’ funds. However peer group comparison in general is just a starting point. Sponsors also need to look at performance in the context of whatever composite benchmark the manager is using. They need to be listening to the explanations of the performance over time, the sources of the relative performance from the different underlying strategies, or changes in asset allocation and impact of market events. In comparing glidepaths, you can look at levels of diversification, depth of the investment schemes across multiple assets, and ability to be more thoughtful and active in relative allocations, for example between U.S. and international markets, or across different fixed-income categories.

Again, the larger context for all of that is the sponsor’s expectations. Did the fund perform as it should have been expected to over time?

**Joan Bozek:** All of those are great points, and rather than be repetitive I’d bring the issue back to plan design. Our industry is clearly working hard to bring together a lot of resources and features into its target-date offerings. A key aspect of performance, when it comes to ensuring the income needs of participants, is being comprehensive in your approach. Sometimes we view 401(k) plan design, benefits packages, and investment selection as separate components, but they’re not.

So, independent of your target-date selection, work on your plan design and benefits package, and work with your participants to encourage them to save and invest more. Ultimately, we believe that good asset allocation and diversification, in an age-appropriate asset allocation, will provide a fine solution for the majority of your employees. There are enough choices in target-date series that you can be confident in whatever choice you and your advisers make. ~
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