Why consider a custom target-date strategy?

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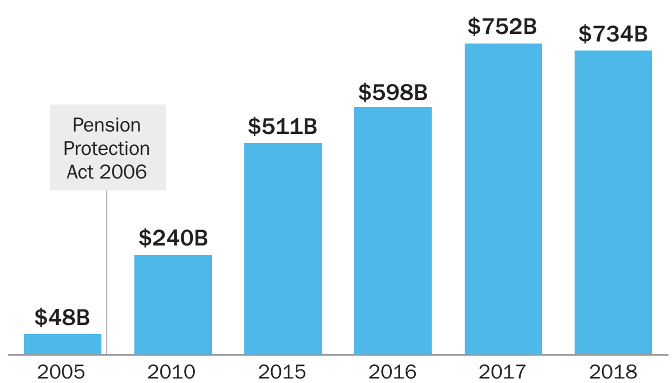
The first article in our series reviewed the evolution of the target-date strategy, concluding with today's latest generation. In this article, we consider how different options compare to these latest custom default strategies and three key considerations for plan sponsors.

Ease and simplicity have made target-date funds attractive to sponsors and participants alike since the early 1990s when they first came on the scene. The subsequent passage of the Pension Protection Act paved the way for target-date funds as a common plan default, which has contributed significantly to their popularity and asset growth.



Source 2005–2018: Investment Company Institute. 2018. *2018 Investment Company Fact Book*: Target Date and Lifestyle Mutual Fund Assets by Account, pg. 183.

Fundamental to the target-date design is the series of funds usually in five-year intervals—where participants select the fund that corresponds most closely to their expected year of retirement. The first-generation target-date funds offered diversified portfolios, and were made up of multiple asset classes, where the glidepath (asset allocation) became more conservative as participants moved closer to retirement.

Later designs have improved on this foundation, where funds can assemble investments from more than one provider, as in the case of second-generation strategies. However, even with these innovations, plan sponsors can still find it challenging to meet the plan's unique plan demographics following traditional models.

The advent of the latest third-generation target-date strategy—custom portfolio models available to many recordkeeping systems today—allows plan sponsors and their advisors to create totally customized approaches, leveraging the strengths of the original mutual-fund-based target-date strategies but providing much greater flexibility to tailor them to plan and participant objectives.

Why consider a custom approach—three key factors

Let's compare two hypotheticals—a traditional target-date strategy and a custom portfolio model series—and consider several key differences in the designs. Both strategies are similar on the surface, each with multiple age-based strategy "sleeves" and the same glidepaths, as shown on the far right of each exhibit, but they differ substantially in several ways:

Hypothetical ABC target-date fund series

	ABC Funds US Large Cap	ABC Funds US Small Cap	ABC Funds International Equity	ABC Funds Core Bonds	Total Allocations	Glidepath Summary	
						Equities	*Fixed Income*
ABC 2060 Fund	58.00%	6.00%	26.00%	10.00%	100.00%	*90.00%*	*10.00%*
ABC 2055 Fund	58.00%	6.00%	26.00%	10.00%	100.00%	*90.00%*	*10.00%*
ABC 2050 Fund	58.00%	6.00%	26.00%	10.00%	100.00%	*90.00%*	*10.00%*
ABC 2045 Fund	57.00%	6.00%	27.00%	10.00%	100.00%	*90.00%*	*10.00%*
ABC 2040 Fund	54.00%	6.00%	25.00%	15.00%	100.00%	*85.00%*	*15.00%*
ABC 2035 Fund	48.00%	5.00%	23.00%	24.00%	100.00%	*76.00%*	*24.00%*
ABC 2030 Fund	42.00%	5.00%	20.00%	33.00%	100.00%	*67.00%*	*33.00%*
ABC 2025 Fund	37.00%	4.00%	17.00%	42.00%	100.00%	*58.00%*	*42.00%*
ABC 2020 Fund	31.00%	3.00%	15.00%	51.00%	100.00%	*49.00%*	*51.00%*
ABC 2015 Fund	26.00%	3.00%	13.00%	58.00%	100.00%	*42.00%*	*58.00%*
ABC Retirement Fund	22.00%	2.00%	11.00%	65.00%	100.00%	*35.00%*	*65.00%*

Hypothetical third-generation client custom portfolio series

	ABC Funds US Large Cap	XYZ Funds Small/Mid Cap	EFJ Funds Group International	UVW Bond Index	MNO Fixed Annuity	Total Allocations	Glidepath Summary	
							Equities	*Fixed Income*
Client 2060 Model	58.00%	6.00%	26.00%	5.00%	5.00%	100.00%	*90.00%*	*10.00%*
Client 2055 Model	58.00%	6.00%	26.00%	5.00%	5.00%	100.00%	*90.00%*	*10.00%*
Client 2050 Model	58.00%	6.00%	26.00%	5.00%	5.00%	100.00%	*90.00%*	*10.00%*
Client 2045 Model	57.00%	6.00%	27.00%	5.00%	5.00%	100.00%	*90.00%*	*10.00%*
Client 2040 Model	54.00%	6.00%	25.00%	7.50%	7.50%	100.00%	*85.00%*	*15.00%*
Client 2035 Model	48.00%	5.00%	23.00%	12.00%	12.00%	100.00%	*76.00%*	*24.00%*
Client 2030 Model	42.00%	5.00%	20.00%	16.50%	16.50%	100.00%	*67.00%*	*33.00%*
Client 2025 Model	37.00%	4.00%	17.00%	21.00%	21.00%	100.00%	*58.00%*	*42.00%*
Client 2020 Model	31.00%	3.00%	15.00%	25.50%	25.50%	100.00%	*49.00%*	*51.00%*
Client 2015 Model	26.00%	3.00%	13.00%	29.00%	29.00%	100.00%	*42.00%*	*58.00%*
Client Liquid Retirement Model	22.00%	2.00%	11.00%	65.00%	0.00%	100.00%	*35.00%*	*65.00%*
Client Annuity Retirement Model	22.00%	2.00%	11.00%	15.00%	50.00%	100.00%	*35.00%*	*65.00%*

These are hypothetical examples and are not representative of any specific investment.

Control and oversight

The third-generation custom portfolio models provide total freedom to build a strategy from available investment options across the landscape of offerings and providers in any desired structure. Sponsors and their advisors can seek to create "better" strategies for their participants.

- This contrasts with the traditional target-date series, which is typically made up of underlying mutual funds all managed by a single offering manager.
- While both strategies have identical glidepaths with allocations becoming more conservative over time, custom portfolio models can be designed to include two retirement offerings—one focused around a liquid bond fund and the other around a fixed annuity. The significant allocation to bond funds is comparable to a traditional target-date approach. However, the custom portfolio's model allocation to fixed annuities can provide participants with the opportunity for guaranteed income in retirement.* So participants in the model can choose a portfolio that employs a significant allocation to a bond fund, the annuity allocation or a blend of both. It is just one small example of how plan sponsors and advisors can tailor a strategy that works best for their participants. They may also opt for additional retirement income strategies, multiple glidepaths (such as conservative, moderate and aggressive), and fewer or more age-based models, as needed.

Improved cost and value relationships

Third-generation custom portfolio models offer plan sponsors greater range and flexibility to create strategies that dial in the most attractive cost-value options. For instance, sponsors can:

- Create models that range from low-cost, very simple vehicles to strategies mixing active and low-cost passive strategies.
- Improve the cost-value relationship through a mix of lower-cost share classes combined with funds that have demonstrated superior performance characteristics.

In contrast, traditional mutual-fund-based target-date funds have little flexibility in managing costs other than to move across share classes or transition from actively managed to passively managed target-date funds.

Retirement income opportunities

Third-generation custom portfolio models allow sponsors and advisors to focus directly on the main reason for retirement plans and strategies: to help participants to and through retirement. This can be done in part by considering more income-focused investments and the fund structure.

- The custom portfolio model strategy in the example above includes a fixed annuity component, a significant departure from traditional mutual-fund-based strategies. The fixed annuity provides exposure to a fixed income alternative with very low volatility and guaranteed interest to improve retirement readiness and the opportunity—*but not the obligation*—to use this fixed annuity through retirement.
- In addition to the use of a fixed annuity in accumulation, strategies can be created that use one or more annuities only at retirement, potentially annuities from multiple providers and a mix of annuity types such as fixed and equity-oriented annuities.
- In the case of traditional target-date funds, their retirement income sleeves really don't address the need for or delivery of retirement income other than being more conservatively postured than other funds in the series. All the work to actually fund and receive income is in the hands of participants. And when they begin to draw down their accounts, there are very real risks—that they live longer, lock in a stock market loss early in retirement, struggle with the sequence of returns, or just plan poorly, and that they can run out of income later in retirement.

Legal and regulatory challenges

It can be very difficult to add a lifetime income component to a target-date mutual fund because of its regulatory classification. Currently, there are only two ways a mutual fund could offer guaranteed lifetime income in retirement.

- It could enter into an agreement in which the income guarantee is provided by a third party.
- It can be offered in association with an insurance product that provides the income guarantee, like a Guaranteed Minimum Withdrawal Benefit (GMWB).

These limitations are not a failing of any particular fund, but rather a shortcoming of the design for the entire category. With custom portfolio models, you have the ability to include a lifetime income component because its regulatory framework is less restrictive in this regard. In fact, it's one of the chief advantages of the customized approach.

Why *not* consider a custom approach?

Until relatively recently, plan sponsors interested in using a target-date strategy in their plan or as a plan default option had to be content with one of the many off-the-shelf funds available in the marketplace because offerings such as custom portfolios were somewhat rare. As time has passed, the choices available to plan sponsors have grown dramatically with recordkeeping platforms better able to accommodate them.

When contemplating selection of a default strategy, plan sponsors and their advisors increasingly may want to consider custom portfolio models along with traditional target-date alternatives as viable options. They offer greater control, more options and the potential for better outcomes—for both the plan overall and its participants.

To learn more about custom portfolio model options for your plan, please contact your TIAA representative.

The next article in this series will delve more deeply into the three broad means of comparing traditional target-date mutual fund series and custom portfolios: control and oversight; cost-value relationships; and retirement income creation.

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* All guarantees are based on insurance provider's claims-paying ability. Withdrawals prior to age 59½ may be subject to a 10% federal tax penalty, in addition to ordinary income tax.

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