

# The Next Generation of Target Date Strategies

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The advent of target date investment strategies in the early 1990s was the start of a sea of change in the way participants save for retirement. Initially developed as a defined contribution (DC) savings vehicle to augment Social Security or defined benefit plans, the passage of the Pension Protection Act in 2006 gave these funds even greater momentum; it established safe harbors for auto enrollment, auto escalation and the Qualified Default Investment Alternative (QDIA). In particular, the QDIA safe harbor provided for the use of products like target date funds that take into account the individual's age or retirement date. As a result, target date funds have become the preferred default strategy for thousands of DC plans across America.

While these funds have been exceedingly popular, over the years, many have believed there was room for improvement. Certainly, we have seen the traditional product evolve, building on its attractive design for potential accumulation. But newer approaches featuring lifetime income options have the potential to lead the market in coming years.

## **A longer view**

To better understand where we're headed, let's take a step back to assess those earlier offerings, which are still available in the market. As we'll see, later generations have preserved the strengths of earlier designs and overcome some of their shortcomings, specifically today's approaches that focus on the income phase as well.

### ***First generation target date funds—simplifying accumulation***

The first generation of target date funds is the style most familiar to plans and participants. They are typically organized as a series of age-based funds (2015, 2020...2060, for example) and managed by an investment adviser who is responsible for the strategy, thus freeing participants from the need to regularly oversee their own investments. All the underlying funds within a target date series are typically assembled from affiliated individual funds.

Target date funds typically provide:

- A series of funds usually in five-year intervals where participants select a fund that corresponds most closely to their expected year of retirement
- A glidepath (asset allocation) that becomes more conservative as participants get closer to retirement

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- A diversified portfolio, which can include domestic and international equities, bonds and cash, in a single fund
- Periodic rebalancing<sup>1</sup>

Some things to be aware of with target date funds:

- As with any mutual funds, the principal value of a target date fund isn't guaranteed at any time and will fluctuate with market changes. The target date approximates when investors may plan to start making withdrawals. However, you are not required to withdraw the funds at that target date.
- They share the risks associated with the types of securities held by each of the underlying funds in which they invest. In addition to the fees and expenses associated with the target date funds, there is exposure to the fees and expenses associated with the underlying mutual funds.
- The principal value of a target date fund isn't guaranteed at any time including the target date.

From our experience, the ongoing turnkey allocation is one of the biggest reasons for the surging popularity of target date funds.

### ***Second generation strategies—allowing for more customization***

While off-the-shelf target date funds have been attractive and made sense for many plan sponsors, several years ago, a second generation, offering customized target date design strategies, began gaining traction:

- First, they enabled the use of funds from more than just one provider—a reasonable concept since it's unlikely that one provider would offer a top choice across all asset classes. Such offerings could therefore include a growth fund from one investment manager, a value fund from another and an international fund from a third.
- Second, they allowed for complete freedom in the design of the glide path, enabling plans to even offer the potential for multiple glide paths across age ranges such as conservative, moderate, and aggressive choices
- Finally, the freedom these strategies offered (to change allocations, fund offerings and glidepaths) made them more responsive to the changing needs of the participant population or the plan.

### ***The third (next) generation—adding an emphasis on outcomes***

First- and second-generation strategies might be described as “accumulation centric”; their improvements focused on the target date fund as an accumulation vehicle. The third generation has brought a new, additional emphasis on retirement income.

Like second-generation strategies, third-generation approaches have continued to allow for underlying investments from multiple providers, flexibility in glidepath construction—including multiple glidepaths—and the ability for the plan to change any element of the strategy as needed. They've also offered something unique: the ability to include cost-effective, liquid annuities<sup>2</sup> for both accumulation and lifetime income in retirement. An allocation to an annuity can be very small or very significant—we've seen annuity usage ranging from 10% to 40% of participants' assets at retirement.

Adding annuity-based retirement income capabilities to a target date approach can have many advantages.

In accumulation:

- A fixed annuity strategy has the potential for competitive returns over time yet experience little, if any, loss of value and less volatility in down markets.
- Introducing annuities earlier reinforces the message that retirement planning is not just about accumulating wealth but creating retirement income.
- Plan sponsors and advisors may do a better overall job at picking annuity strategies compared to individual participants, who may also benefit from institutional pricing for in-plan use rather than individual pricing in retirement. This is a critical point as annuities are popular retirement income vehicles, yet many annuity contracts in the individual insurance marketplace may carry very high fees and expenses.

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At retirement:

- Full liquidity in the annuity component gives participants the option, *but not the obligation*, to use the annuity in retirement. They may decide to annuitize all or portions of the position, continue holding the annuity as an ongoing investment, or sell it to invest elsewhere without any additional cost or penalty. It's important to note that the decision to annuitize and receive lifetime income may be irrevocable and there may be tax consequences for withdrawing or selling assets in the retirement plan<sup>3</sup>.
- Significant income advantages can accrue to participants who choose to annuitize in retirement. Depending on the fixed annuity they can pay out at a rate equivalent to roughly 4% to 7% (or more) of capital, depending on the provider and contract terms. By comparison, a systematic withdrawal rate from a mutual fund portfolio of any more than 3% to 4% may result in participants running out of assets. Given these differences, it would not be unusual for a participant to enjoy more income on capital from annuitized balances than could be prudently generated from mutual fund systematic withdrawals.
- Fixed annuity income is guaranteed for life (subject to the claims-paying ability of the provider). Participants will not need to worry about running out of money or overspending their wealth for the portion that is annuitized.
- Collecting annuity income is easy. Participants can receive a check in the mail or a direct deposit without having to worry about logging in to liquidate assets or calculate withdrawal amounts.
- Finally, these third-generation strategies that include annuities can offer several potential retirement income options for participants, including the ability to mix and match lifetime income and traditional mutual fund investment options for various postretirement needs.

As you can see, the third generation has included all of the improvements from second-generation strategies while adding a lifetime retirement income option. It really is the next generation of plan defaults.

Despite these innovations, we believe the only practical options available to most plans have been the traditional first-generation off-the-shelf fund series. If a plan sponsor wanted to offer the benefits of second- or third-generation target date strategies in a traditional mutual fund format on their menus, let alone as a default, creating such an offering has been prohibitive from a legal, administrative and financial standpoint. Until now, that is.

### Making newer generations possible: The Custom Portfolio

The second- and third-generations of target date strategies were made possible in large part due to the creation of a concept known as a “custom portfolio”. The Custom portfolio is actually a capability that is already widely available across many recordkeeping platforms. Sponsors may not realize it, but their recordkeeping platforms may allow for the creation of asset allocation models that make use of individual investment options on a plan menu to build custom solutions tailored to the specific demographic needs of the plan. Participants can select a custom portfolio model through traditional plan enrollment tools, or they can be defaulted into them since the models can be designed to be QDIA eligible.

An example of how this works:

- A plan sponsor may select an advisor skilled in financial modeling to build a custom portfolio as the plan default with the look and feel of a traditional target date option but with additional features.
- The advisor will create a set of age-based allocations along a glidepath of their design and populate them with underlying investment options that are already available or that can be easily added to the plan menu.
- Once completed, reviewed and approved with the plan sponsor, this new custom portfolio model can be put into place as the plan's new default vehicle in relatively short order.

The resulting new custom portfolio might, for example, offer:

- Multiple glidepaths for conservative, moderate and aggressive investors
- Lower-cost fund choices
- Diversification across many fund companies<sup>4</sup>

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- A mixture of both active and passive strategies
- The ability to accumulate in low-cost fixed annuities as a way to help reduce investment volatility and provide a degree of guaranteed income in retirement

### ***A word about fiduciary responsibilities***

The plan sponsor can choose the level of control it prefers in defining the asset allocations for their model solution. The plan sponsor as fiduciary can select the investment options to meet the asset allocation requirements on its own or with advice from its 3(21) fiduciary advisor, or can delegate selection to a 3(38) investment manager. Fiduciary considerations for a custom solution can include:

- Cost
- Investment control
- Alignment with plan demographics

### **When does a customized solution make sense?**

There are a host of reasons for considering customized approaches. Plans may be able to reduce costs and expand and improve the choices available to not just active participants, but options today also offer portfolio models to retirees. Customization enables participants to choose their own risk tolerance—conservative, moderate or aggressive paths within age groups. It also provides flexibility to offer more sophisticated paths for some and more simplified paths for others. These features, together with the integration of a lifetime income component, can also help improve retirement readiness and better outcomes for the plan overall. The continued evolution of the target date strategy is making a custom portfolio option that may have seemed out of reach a more reasonable consideration for sponsors and plans of all sizes.

*This is the first in a series of articles about the newest generation of target date strategies. Future articles will focus on different elements of these strategies to provide a more comprehensive understanding of features and implementation. You can also contact your TIAA representative now to find out how custom portfolios may work for your plan and participants.*

<sup>1</sup> Rebalancing does not protect against losses or guarantee that an investor's goal will be met.

<sup>2</sup> Not all annuities may be fully liquid. There may be restrictions on withdrawals. There are tax implications when withdrawing both before and after age 59½.

<sup>3</sup> Taxes may apply and a 10% tax penalty will apply before age 59½.

<sup>4</sup> Diversification does not guarantee that you will not suffer losses when investing.

**Mutual Funds, including Target Date Funds are available for sale by prospectus. The prospectus contains more complete information including fees and expenses. It should be read carefully before investing. Custom Portfolios typically have a program description which contains detailed information on the offer. A model service provider should be able to provide this type of information.**

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