Defined Contribution Institutional Investment Association

2025 M Street, Suite 800
Washington, DC 20036
www.dciia.org

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The "To vs. Through" Target Date Debate: Is There a Better Way to Frame the Glide Path Discussion?

By: Richard Davies and Ben Jones, Russell Investments; Anne Lester, J.P. Morgan Asset Management; and Peg VanWagoner, American Century Investments, Inc.

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Target-date funds have received significant attention following enactment of the Pension Protection Act of 2006 (PPA), which designated target date funds as qualified default investment alternatives and provided new fiduciary protection for plans electing to use them. As a result, adoption of target date funds as default investments has become widespread. The funds have continued to attract attention following the market downturn that began in late 2008.

In those challenging years, many retirement plan participants, and even plan sponsors, claimed not to understand exactly how their target date funds were invested. Legislators, regulators and plan fiduciaries questioned how it was that funds with the same target date label, described in the same general way, could be designed with such widely varying asset allocations, which in turn delivered very different investment performances. Not surprisingly, there has been a call for increased disclosure of the funds' underlying construction methodologies, with a particular focus on their exposures to equities and other growth assets.

To simplify a very complex issue, market observers, consultants and plan sponsors have cast the target date discussion as a debate between two camps:

- The "to" camp – those who manage the reduction of equity exposure over time to a target date at or near retirement, and
- The "through" camp – those who manage the reduction of equity exposure *through* retirement to a target date 15 or 20 years beyond.

DCIIA believes that these naming conventions can be misleading, in that they imply a choice between one of two straightforward design options. Unfortunately, it's not that easy. We will suggest a more thoughtful approach. While many DCIIA member firms hold definite views about the most appropriate way to construct a target date asset allocation and glide path, in this paper we have worked collectively to create an objective and balanced presentation of the factors to be considered in selecting or building target date portfolios. We accept that there is no single right answer, and that sponsors must consider what is right for their plans and participants. In target date design, there is no such thing as "one size fits all."

More Alike Than Not

Before we get started, we should note that any target date design – or any qualified default investment alternative (QDIA) – represents a great step forward from the do-it-yourself investment approach that has dominated DC decision making historically. As a category, target date portfolios have allowed the majority of participants to benefit, with little or no effort, from embedded advice and well-diversified asset allocation. Most participants using these portfolios are far better off today than they would have been without them.

Even though PPA endorses asset allocation defaults and provides important safeguards for plan sponsors, plan decision makers still remain responsible for the target date selection process, just as they would with any other investment option. Arguably, this default selection is far more important than most.

The good news is that despite the variations in design that we will discuss today, target date portfolios are more alike than different. All target date portfolios:

- Are well diversified (though plan decision makers would be well advised to understand underlying differences);
- Are professionally managed;
- Are designed to reduce exposure to market risk automatically as participants age;
- Share the objective of preparing for income generation in retirement, and
- Continue to manage assets post-retirement.

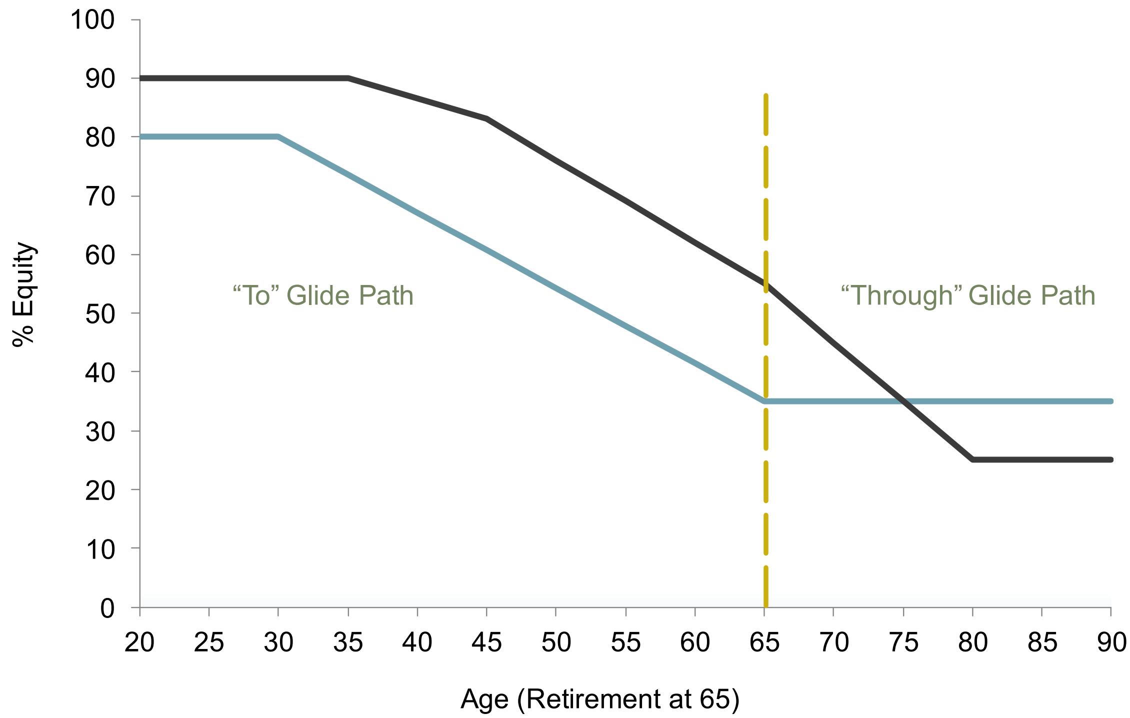
Misleading Terminology

But before we suggest a better way of approaching target date glide path selection, let's make sure everyone understands the commonly used "to" and "through" terminology. It really boils down to examining when the minimum equity exposure is reached – at retirement, or later.

- **To:** The investment industry has characterized the "to" camp as proponents of the idea that target date funds should be designed primarily to build savings up *to* an individual's target retirement date, traditionally around age 65. Target date funds exemplifying the "to" principle reduce the equity (and other risky asset) allocations to their most conservative levels at an individual's target retirement date, typically with flat or static allocations during retirement years.
- **Through:** In contrast, "through" advocates have been defined as those who believe target date funds should be designed to help investors save and then maintain spending *through* retirement. The "through" camp reasons that because of increases in average longevity, investors need their accumulated balances to last them long after retirement. Target date funds employing the "through" approach have an allocation to stocks at an individual's target retirement date that is typically, but not always, higher than "to" managers' allocations and that continues to decline for 15 to 20 years after retirement.

Most plan participants using target date portfolios are far better off today than they would have been without them.

“To” Vs. “Through” – Easy To Visualize



One reason the “to versus through” terminology has caught on is that the concept is so easy to visualize. The “to” glide path flatlines at age 65, and the “through” glide path continues to slope down deep into retirement. (Please note that these glide paths are purely hypothetical – they don’t represent specific managers.)

The concepts of “to” and “through” are easy to understand and visualize, but they are also surrounded by a number of misconceptions. Specifically, they:

- Cannot be confused with low and high equity – a “to” glide path may be high or low equity at retirement, and a low equity glide path at age 65 may be high equity at age 85;
- Should not be thought of as safe vs. risky – both expose participants to risks, just of different types;
- Don’t describe the correct amount of equity – either at retirement, where target date funds exhibit the greatest amount of variation, or at any other point in a participant’s life;
- Do not address the definition of success – for either the participant or the plan sponsor;
- Should not imply that “to” managers don’t care what happens after age 65 – they do, and they will continue to manage portfolios throughout retirement in the best interests of participants, and
- Should not imply that “through” managers assume all participants will remain in the target date funds throughout retirement – they view their asset allocation as appropriate for participants rolling assets into IRAs.

*It could be that a **“to” glide path is** the best way through retirement, or **that “through” is** the best way to retirement.*

The shorthand of “to” and “through” is not a replacement for thoughtful evaluation. “To versus through” is not a choice to be made – it is the end description of a deliberate selection process. Depending on a plan’s philosophy and participant demographics, it could be that a “to” glide path is the best way through retirement or that “through” is the best way to retirement.

Defining and Measuring Success

We believe the selection process begins with the plan fiduciaries' describing success for a participant in their plan. There are three steps to the process:

1. **Definition: What objectives are we trying to achieve?** Plan fiduciaries may want to provide participants with the maximum opportunity to build account balances during their working years. Others may be less concerned with generating the largest possible nest egg and will focus instead on maintaining a stable balance in the years immediately before expected retirement. Yet other sponsors may emphasize maintaining participant spending power during what may be 30-plus years of living in retirement.
2. **Measurement: When will we evaluate outcomes?** The point of measurement will likely be closely related to the plan's objective. Plan fiduciaries may choose to focus on results for near-retirees; to model results for participants deep into retirement; or to measure results for all participant cohorts over their full life cycles.
3. **Assessment: How will we know if we are on track?** Measuring the success of a target date program is challenging, and it differs from the approach to evaluating a single asset class investment (such as, for example, a large cap value fund). Short-term performance rankings relative to target date universes, while interesting, shed little light on investment strategies designed to perform over a lifetime, and it cannot be hoped that the data will reflect the varying objectives of plan sponsors. Peer group comparisons may be useful in helping investment committees understand how different their portfolios are from the norms, but cannot alone tell them whether they are on track to achieving their desired outcomes. Rather, plan sponsors will need to use a variety of tools, including simulation analytics that are designed to help them assess their progress toward hitting long-term income replacement targets.

Assessing Risk Trade-Offs

Since the equity market sell-off of 2008, there has been renewed focus on managing and reducing risk in target date portfolios. When plan sponsors and participants talk about "risk," they are almost always referring to market risk and equity risk in particular. But there are many types of risk for participants, and the target date selection process involves balancing one risk against another in efforts to meet the broad needs of the majority of participants. There is no such thing as a risk-free portfolio.

- The volatility of equity market returns is the risk most commonly understood by market participants. Interest rate risk (and its impact on "safe" bond holdings) is less often considered.
- Longevity risk – the risk of outliving one's assets – is well understood by insurance companies, but underappreciated by most DC participants.

Several other risks – inflation risk, shortfall risk and spending-rate risk – all relate to the maintenance of adequate spending power during what will be, for many, a longer than expected and potentially more unpredictable and expensive retirement period. Of course, the ultimate risk-mitigation strategy in a successful retirement plan is getting participants to save adequately during their working years. No investment strategy can make up for a low savings rate or, for that matter, excessive spending in retirement. But these topics are beyond the scope of our paper.

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Glide Path Selection

So what process are we suggesting for selecting the right target date fund? It involves three elements: employer philosophy, plan sponsor objectives and assumptions regarding participant behavior and engagement.

1. EMPLOYER PHILOSOPHY:

The judgments involved here are highly subjective and surround questions that only the sponsors can answer for their own plans. Issues concern the proper role of the sponsors and financial liabilities, both present and future:

- What social contract do we have with our employees? Companies with a DB heritage may feel a moral obligation to look out for workers in retirement.
- What is our value proposition for recruiting and maintaining workers? In some industries, a full life cycle approach to retirement programs may be viewed as a competitive advantage.
- What liability do we want to accept for retirees? The costs of servicing and potential litigation are concerns for some plans.
- Can we increase purchasing power with plan providers by leaving retirees in the plan? More assets and participants will allow plans to negotiate better fees with asset managers and record keepers.
- What limits do existing plan documents place on us? Some plans may force workers out at separation.
- What do our participants want to do with their funds at retirement? There may already be a history of leaving assets in the plan post-retirement.

2. PLAN SPONSOR OBJECTIVES:

The process of setting plan objectives better lends itself to quantitative evaluation and critical thinking. Yet in dealing with different constraints, reasonable plan fiduciaries may reach very different conclusions about what is right for their participants. We've grouped objectives and constraints into five categories and provided examples of the different criteria plan fiduciaries might adopt, and how these criteria could drive a glide path decision. Instead of using the inappropriate "to versus through" descriptions, we have reframed the choice as being when to minimize equity exposure: at retirement, or years into retirement.

Objectives / Constraints	Equity minimized at retirement ("To" philosophy)	Equity minimized years into retirement ("Through" philosophy)
Accumulation	Focus on accumulating a high probability minimum target balance at retirement	Focus on building a high median expected balance to sustain spending in retirement
Risk budget and participant experience	Smooth the ride: trade potential return for lower volatility especially near and in retirement	Embrace a bumpier ride: accept higher volatility for higher return potential during work and early retirement
Retirement preparation	Focus on asset preservation and managing sequential risk approaching retirement	Focus on building and sustaining spending capacity throughout retirement
Advice preparation	Reduce likelihood of bad outcomes late in employment in preparation for de-accumulation and the potential help of a professional	Embed retirement investment advice in target date portfolios; whether assets remain in-plan or are rolled to an IRA should not impact allocation decision
Annuitization option	Prepare participants for possible total or partial annuitization	Prepare participants for systematic withdrawal

For example, plan sponsors deciding to minimize participants' equity exposure at age 65 may be willing to trade off a potentially higher ending account balance for lower volatility of portfolio returns in the period immediately preceding retirement. This choice could be driven by the view that the plan's objective is to target a minimally acceptable floor account balance, generating a target income replacement ratio for all participants; or it could be driven by company initiatives to encourage annuitization at retirement. Or fiduciaries may simply not want to expose their participants to the risk of a sharp portfolio decline, and the resulting emotional distress, in the final years of employment, when their portfolios are most vulnerable. If such a sudden market shock were to happen, the "to" glide path may result in a higher account balance at retirement and greater ability to meet income needs through retirement than a "through" glide path.

In contrast, plan sponsors selecting a glide path that maintains higher equity exposure at retirement, and that continues to de-risk post-retirement, may believe that maintaining greater exposure to equity assets is the best way to provide adequate income during a potentially long period of retirement. They might conclude that participants entering retirement with the highest possible account values is a valid objective, especially if a high percentage of participants leave assets in the plan when they become retirees and are therefore dependent on asset allocation guidance (via the QDIA) from their plan. Even with a severe market downturn immediately preceding retirement, the retirement portfolio of a higher equity target date series may still have a larger balance than a more conservative glidepath due to superior returns in earlier years.

3. ASSUMPTIONS REGARDING PARTICIPANT BEHAVIOR AND ENGAGEMENT:

Forecasting future behavior is an interesting part of the target date debate. Does a plan want to assume past and current “bad” behavior, possibly driven by a world view that the DC plan was designed only to provide supplemental income? Or might plan fiduciaries take steps to improve future behavior, now that participants will need to rely on their 401k balances for 25 to 30 years, or even longer, in retirement? Plan sponsors will have to decide which sets of behaviors they project for their plan participants, and which actions they are willing to take – if any – to influence them.

Current behavior	Possible future behavior (?)
Loans taken during employment Participants withdraw assets at separation or retirement • Rolled over into an IRA? • Spent immediately? • Spent early in retirement?	Loan usage discouraged by plans Participants more likely to remain in plan at retirement Account balances managed to maintain sustainable spending Greater annuitization of balances
Why? DC plan supplemental for many Self-directed philosophy Accumulation framing in education Aggressive rollover marketing	**Why?** DC plan now only pension for most Post-PPA automation philosophy Retirement income framing in education Plan communication encouraging retirees to remain in plan In-plan guaranteed income insurance solutions

Assumptions about future participant behavior can help guide a plan sponsor’s target date choice. For the participant who is likely to spend down the account balance during a handful of years after retirement, perhaps any target date glide path will do, given that the goal of lifetime income may be simply unattainable. To best serve the participant who intends to sustain income from a 401k balance through disciplined spending in retirement, plan fiduciaries must follow a more thoughtful selection process.

Conclusion

As catchy and appealing as the language may be, “to versus through” is not a choice; it is at best a graphical description of a target date glide path selected or constructed in a thoughtful evaluation process. All target date portfolios, whatever their designs, are more alike than not. They represent a step forward for the plan and for most of the participants who use them, either through default or active selection. Unfortunately, traditional performance rankings will give plan fiduciaries little help in selecting or designing a glide path and an underlying asset allocation. Plan trustees and their advisors will need to roll up their sleeves. Analytical tools and modeling approaches can assist in the decision-making process, but fiduciary decisions on target date objectives and assumptions about participant behavior and capital market returns will have a large impact on the outcome of the selection process.

About DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.