TIME IS ON YOUR SIDE. *YES IT IS.*

20 YEARS INTO THE TARGET-DATE FUND REVOLUTION

Target-date funds (TDFs) are now so commonplace—found in up to 80% of defined contribution (DC) plans, according to some estimates—that it is difficult to remember how long they took to gain acceptance. Seven years after they were introduced in 1993, there were still only a handful of fund suites in the market. This slow uptake did not surprise Chip Castille, currently head of BlackRock's U.S. and Canada DC business and a member of the original team that created the first target-date fund. "They were really revolutionary," explains Castille. "The idea that you could manage asset allocations for a large group of people based on their time to retirement was a radical departure from what was done in the past."

The number of target-date fund suites available today, and the asset flows into these funds, suggests that the revolution has been won. PLANSPONSOR spoke with Castille; Larry Tint, chairman of Quantal International, senior managing director and partner at Cantor Fitzgerald and former U.S. CEO of Barclays Global Investors; Sue Walton, director, Towers Watson Investment Services; and Marcia Wagner, of The Wagner Law Group, about the lessons learned from 20 years of target-date funds and the challenges for the future.

PS: What was the problem you were solving for when you developed the first target-date fund?

TINT: Most 401(k) investors, at the time, steered by using their rearview mirrors and moved into asset classes that had recently done well. Most investors were afraid to pull the trigger, to leave an asset class that had performed well and to reallocate into one that hadn't. They didn't really understand the way the long-term investment decision process should evolve.

So we came up with the idea of creating a fund that would make decisions for the individual and leave him free to focus on the time horizon and risk level that were appropriate.

I had just finished a business partnership with William F. Sharpe, where we acted as investment managers and asset-allocation specialists for large pension funds. In 1990, after Bill won the Nobel Prize in economics, he continued to consult, and I joined Barclays Global Investors, which is now BlackRock, so that I could manage money based on the research we had conducted.

I wanted to be able to provide the same kind of quantitatively correct and focused asset allocation to individ-

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uals that we had provided to corporations through Sharpe-Tint. We had developed technology around planning horizons and appropriate levels of risk that morphed the portfolio through time, and I wanted to be able to provide a similar structure to individuals. Commingled funds geared to specific target dates allowed us to provide that structure inexpensively to DC clients.

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CASTILLE: At the time, most investors created an asset allocation and changed it in response to the market or, at best, predicted changes in the market. Obviously, this is a challenge even for experienced investment managers. But, with the increased focus on DC plans, that is exactly what we're asking people who did not have the insight or interest to do. Target-date funds reduced a complex array of investment questions to one simple question that most 401(k) participants could answer: When do you need the money?

PS: Why did the funds take time to gain traction?

TINT: Like any new idea, it took a while for people to understand and accept. There were two main benefits they needed to appreciate. The first was that a better structure for their investments accurately took into account their time horizons and the risk character of various asset classes. Second, instead of having to pay an adviser 100 basis points a year to manage their account—which over a long time period can reduce a portfolio's value by 30% or 40%—they could now get inexpensive, professional management of their assets.

CASTILLE: I think one of the turning points was in 2001 when the dot-com crash occurred. A lot of people were very upset about what had happened within their 401(k) accounts. Plan sponsors, regulators and individual participants saw the wisdom in investment products that aimed to produce a return above inflation but that were still prudent from a risk-management standpoint.

At around the same time, the DC market shifted toward an unbundled approach so that other providers were able to enter the market. Those two factors combined to show progress. If you look at the early 2000s, you'll see that target-date fund AUM [assets under management] began doubling nearly every year. At that point, regulators started to look at ways to provide some safe harbor protection for investment products such as target-date funds, which, of course, led to the Pension Protection Act [PPA]. Post-PPA, you just saw an explosion of assets migrating to target-date funds.

Today, anywhere between 15% and 20% of DC assets are in target-date funds—with reports of 80% of contributions going into them. I regard target-date funds as one of the more remarkable innovations in financial services over the past 20 years. The proof statement is in the DC asset flows.

TINT: I also think that, as assets in 401(k) plans became the predominant source of retirement benefits, perspectives changed. It's very interesting: One of the first firms that we went to talk to about the LifePath Funds was General Motors. They told us that our structure for the target-date funds was backwards. They said that if you had been at General Motors for 40 years, you were well taken care of from a retirement standpoint and what you really wanted in your 401(k) plan was some "funny money" to buy a boat or a vacation home or something like that. As participants approached retirement, and their pensions became more and more secure, at GM they could take *more* risk with their 401(k) plan rather than less risk. This was certainly a special case.

But, as assets in the larger DC world grew and assets in the DB [defined benefit] world became less important for most employees, people focused more on the appropriate way to guide the structure of the DC money. As focus was brought to bear on these funds, the notion of having professionally structured plans targeted to a particular time horizon became more and more appealing. And certainly the market crashes that occurred in the period tended to reinforce those behaviors.

PS: Why do you think regulators "sanctioned" target-date funds by providing safe harbor protection?

WAGNER: The thinking, as I see it, was that the Department of Labor [DOL] came to the realization that, with the demise of DB, employees were left in the untenable position of having to invest their retirement money like professionals. The DOL made a policy decision that being invested over the long term in a low-risk issue, such as a money market fund or stable value, wasn't prudent.

Considering the financial crisis, they timed the decision poorly. The policy decision essentially transformed the qualified default investment alternative [QDIA] marketplace into an equity-based target-date-fund marketplace. The thinking was that employees' inertia could be used to their own benefit and appropriate long-term investment.

PS: Why did consultants and advisers ultimately buy into target-date funds?

WALTON: As Sue suggests, part of it was the recognition that participants were being put into the position of trying to be investment managers for their own portfolios. It is the classic question: Do participants really have the time, knowledge and interest to manage their portfolios? The flexibility to outsource their investment management and asset allocation, whether they were automatically enrolled or elected to invest in a target-date fund, solves that problem for participants.

PS: What were some of the kind of unintended consequences of target-date funds?

WALTON: If target-date funds became the "set it and forget it" investment for participants, they became the "set it and forget it" choice for plan sponsors as well. There was a feeling after PPA that "Well, we got the blessing of the DOL and we made our choice." Increasingly, plan sponsors are recognizing—or their consultants are reminding them—that their overall benefits may have changed and that the objectives for the plan and the target-date fund may have changed. For example, maybe the plan sponsor has closed down the DB plan. Or the company now auto-enrolls participants so what was once just a choice on the menu is the default option.

Target-date fund choices need to be actively reviewed and re-evaluated as plans evolve.

CASTILLE: One unintended consequence is that when the PPA extended safe harbor protection to target-date funds, it made further innovation more difficult. For one thing, people began to think that the PPA "created" target-date funds. This is clearly wrong; the PPA recognized a trend in the market and supported it. Unfortunately, this has created a belief that we need to wait for regulators to solve problems rather than testing new solutions ourselves. Another is that the regulations were written to address target-date funds as they existed in the mid-2000s. As we've tried to add income features to target-date funds, it has been difficult to get clear visibility around how this meets the QDIA provisions in the PPA.

WAGNER: To add to Chip's comment, one cannot regulate a functioning marketplace without having unintended consequences. No one is wise enough to anticipate everything. That's not how humanity works. It only makes sense that in an era of heightened enforcement and litigation, people are going to favor the most conservative interpretation when complying with regulations. That, by definition, inhibits innovation.

TINT: The intended consequence was removing the pressure on the participants to try to become financial experts. They had had a choice in the past of either trying to do it themselves, which generally didn't work, or hiring somebody else, generally a very expensive way to accomplish the task. All of a sudden, here was something that allowed them to put their money into an investment and relax, knowing that it was being professionally managed at relatively low cost and that they didn't have to make those decisions. That began to give investors the confidence that their retirement assets would eventually be adequate.

PS: As target-date funds become even more prominent, do you think we'll see plans conduct more re-enrollments?

WAGNER: There is an ongoing revolution in how we view DC plans. Target-date funds come from the same thinking behind auto-enrollment and auto-escalation. It's that we can nudge people into doing what's in their best interest. I think people do know what's in their best interest. Re-enrollment is voluntary in that people can opt out, but it's a slippery slope to making participation mandatory. I fear for the unintended consequences of making anything mandatory.

Theoretically, if the plan sponsor's objective is to make sure that as many participants as possible have an appropriate asset allocation, given their time horizon, and are in an appropriately diversified invest-

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ment, then re-enrollment into the default option is the right thing to do. But there are operational challenges. What are the other investments? A re-enrollment may be considered a company-directed event that could invalidate the provisions of a stable value wrap contract. Or, if there is a lot of company stock in the current plan, they need to consider how a re-enrollment might impact their stock price.

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PS: What do you foresee for the future of target-date funds?

TINT: The big question for these funds is the same that any institutionally run portfolio has: What are the expected returns of the various asset classes and what's the optimal way to combine them into a diversified portfolio? That question certainly has not been completely answered by the existence of target-date funds. They merely allow an individual to get the benefit of knowledgeable and informed opinions and technology to make that decision.

There's also debate regarding the best way to optimize the portfolio at any point in time, taking into account its risk tolerance and its investment horizon. That debate will probably go on forever.

We could potentially create different versions of target-date funds to accomplish different purposes. Normally they're designed to accumulate the amount of money a person is expected to need at retirement. But there may be other structures that could benefit somebody who, for example, will stop paying a mortgage in 15 years or who will have some other change in his financial circumstances other than retirement that should be taken into account in his fund.

I think that there can be nuances that will affect how target-date funds are managed and how investors should manage personal assets outside of that structure.

CASTILLE: I can give you a peek into what we're working on at BlackRock. Probably the most important is trying to figure out how to work in today's regulatory environment so that the target-date fund can be used as a source of lifetime income. We think it is critical to make room for an income provision in the target-date fund universe. Unfortunately, we've found it to be difficult to do because of the chilling effect from the great protections that the PPA provided.

Following on Larry's comment about intended consequences, it's also important for people to understand that various target-date funds are actually trying to achieve different things. Some providers are focusing on capital preservation. Others are focusing on growth potential. We tend to focus on stable consumption. With the increasing ability to customize target-date funds, these differences are only to become more important to understand.

And, then the last piece is: I think you'll see glide paths be redesigned. As target-date funds become a larger and larger part of many workers' portfolios and represent more and more of their household assets, there will be different ways to redesign glide paths to serve different investment objectives.

WAGNER: The government must realize that there is a need for some type of income replacement in retirement that is guaranteed. That's the next step in the transmogrification of DC into something like DB.

WALTON: If we are really trying to mirror the experience participants had in the traditional DB pension plan, then income has to be a consideration in the future. Today, most participants are automatically enrolled into a target-date fund. They don't have to think about their investment management. The natural evolution would be to have some income component within the funds. I also think we'll see further customization. Target-date funds are trying to solve an issue for a broad cohort of people as well as take advantage of their collective buying power. I think we will see more solutions that can be tailored to the needs of smaller cohorts. ■

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