

Comparing the Risks and Returns of “To” versus “Through” Target Date Funds

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Most target date funds are **THROUGH** funds, as opposed **TO** funds. It’s important to know the difference between these two types of target date funds. In this article we compare and contrast the risks and rewards of these two approaches.

An important distinction has been uncovered by the June 18 SEC and DOL joint hearings on target date funds (TDFs). Most TDFs are “**THROUGH**” funds, designed to serve investors past retirement, to the grave. These funds would be best re-labeled as “target death” or “lifetime” funds, and the date in the fund name should be changed accordingly, perhaps using the investor’s birth date. It remains to be seen how the SEC will react to this need for clarification. Because **THROUGH** funds are designed for a lifetime they are somewhat aggressive at target date, with the average 2010 fund allocated 45% to equities in 2008. This led to an average 25% loss in 2008, which prompted the joint hearings. 2010 funds are earmarked for those retiring between 2005 and 2015. The majority opinion of the witnesses at the hearings is that **THROUGH** is the way to go because participants need to be protected against longevity risk, and fund companies know the appropriate glide path to provide this protection because they have run sophisticated computer simulations. **THROUGH** funds are the likely subjects of SEC and DOL rulings, which the industry is waiting for with great anticipation. Importantly, most if not all participants do not leave their savings with the plan when they terminate employment, so practice defies the objective of **THROUGH** funds.

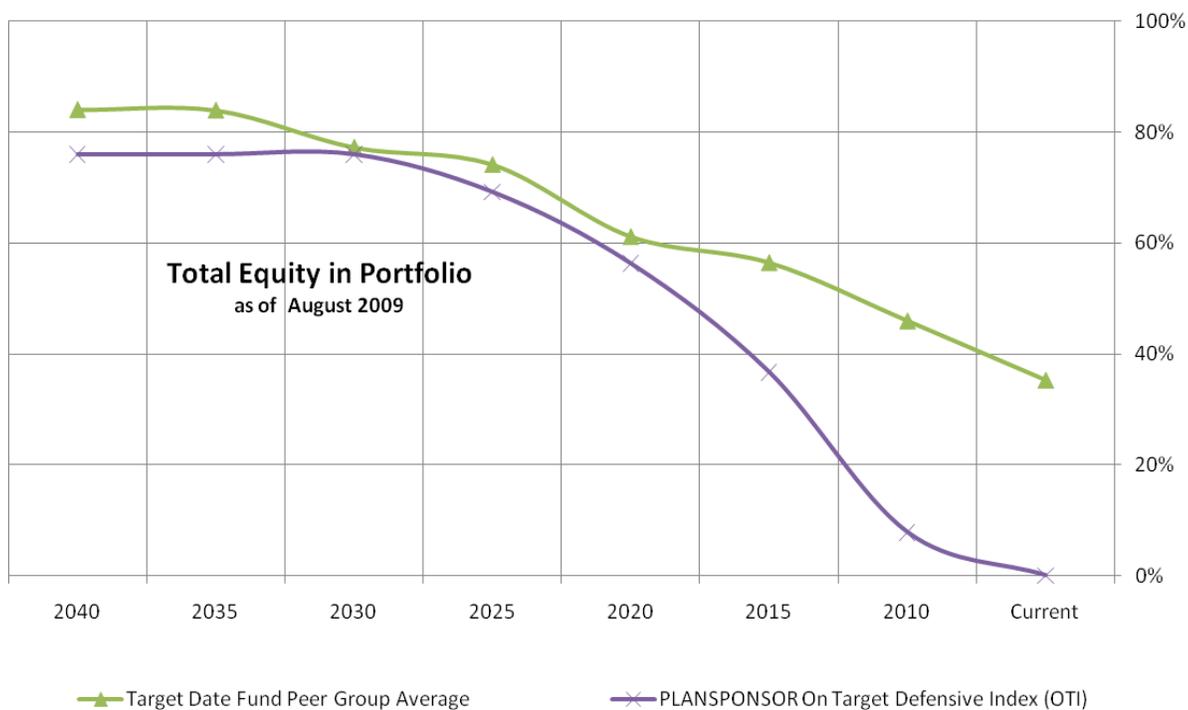
But there is an alternative to **THROUGH** funds called a **TO** fund that plan sponsors should also consider, if for no other reason than it expects participants to withdraw at the target date, as is the practice. Plan sponsors are the only ones with the fiduciary responsibility for selecting and monitoring TDFs. The glidepaths of **TO** funds are designed to end at the target date, requiring the plan participant to do something quite extraordinary – think and act. Why? Because the target date fund has done its job: It has brought the investor **TO** the target date and now the investor needs to assess what type of portfolio might best meet his or her specific needs at that point. In this article, I end the **TO** fund example at zero in equities in keeping with the PLANSPONSOR On-Target Defensive Indexes, designed and maintained by Target Date Analytics. Ending the glidepath entirely

in safe investments protects the investor during the transition from accumulation to distribution, that is, while the investor is deciding on retirement investments.

There's a good chance that plan participants and sponsors thought they were buying **TO** funds, if for no other reason than the date in the fund name. Certainly those who have purchased target date funds for college tuition believe they are buying **TO** funds. The perspective of a **TO** fund provider is that a well-constructed generic glide path can serve the majority during their working lives, but retirement is far too complex for a one-size-fits-all solution. It further presumes that plan participants are not all brain dead, so they can in fact make their own decisions about matters that affect the rest of their lives.

The following graph compares the glide paths of these two approaches. The **THROUGH** approach is exemplified by the peer industry average allocation through time. The **TO** approach is represented by the PLANSPONSOR On-Target Defensive Index, which is the approach employed by SMART Funds® collective investment trusts of Hand Benefits and Trust.

TO (OTI) Glide Path Compared to THROUGH (Peer)

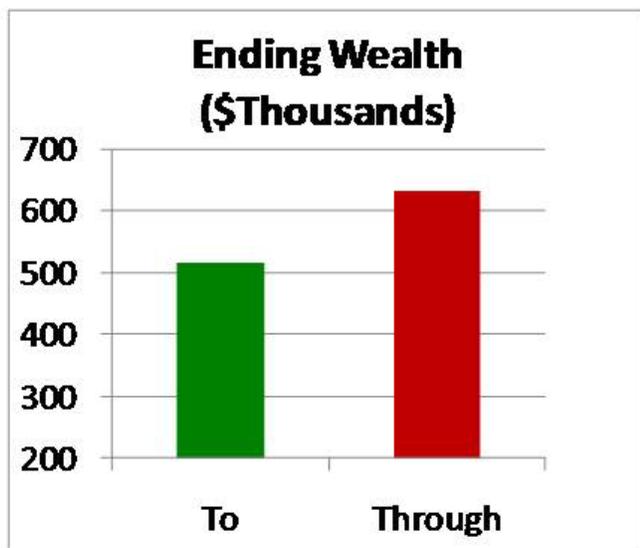


As you can see, the two paths are quite similar at distant dates but diverge as the target date approaches. A logical question for the plan sponsor is what does this do to risk and reward of these paths. To answer this question, we have measured ending wealth and risk for all 40-year glide paths going back to 1926. There are 44 such 40-year paths ending in calendar years. It is assumed that the

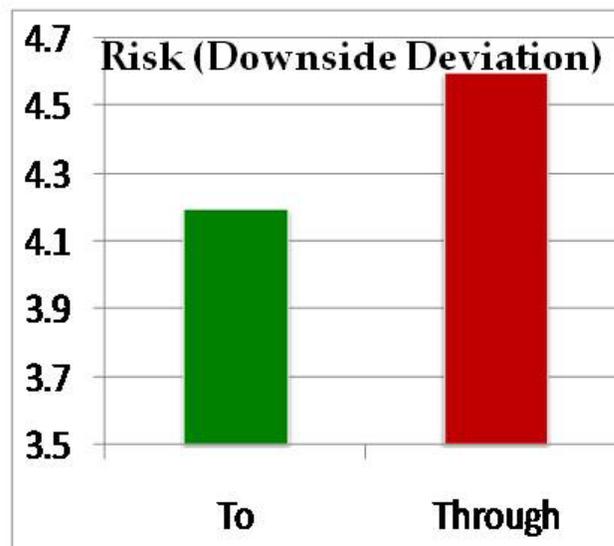
investor contributes \$1,000 initially and increases this \$1,000 by 3% per year, so he contributes \$1030 in the 2nd year, \$1061 in the 3rd year, etc. The risk measure is dollar-weighted downside deviation. The rationale for this measure of risk is provided in [Surz 2009]. The following graph summarizes the results.

To versus Through Glide Path Comparisons 1926-2008 (44 40-year periods)

(\$1,000 initial balance, plus \$1k/yr increasing at 3%/yr)



Through is 4% Richer



Through is 8% Riskier

The two approaches are quite similar, with the **THROUGH** path delivering somewhat greater wealth but with more risk – 4% more wealth on average with 8% more risk. But this is for the entire 40 years, where the two paths are quite similar for all but the last 10 years, at which point the **TO** path diverges to zero while the **THROUGH** path ends at 35% in equities at the target date. This last ten years is critical.

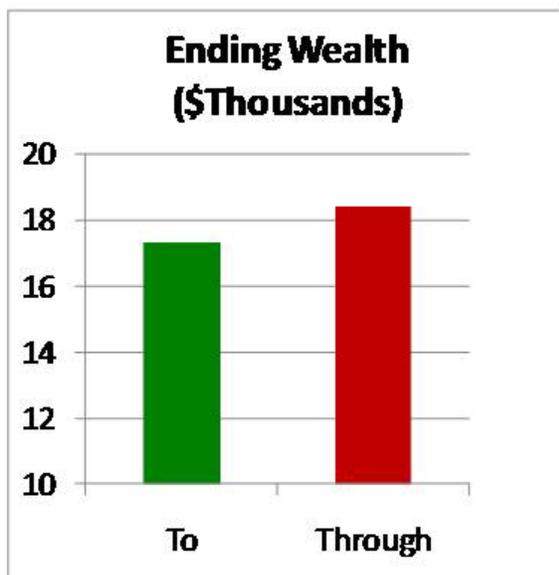
The transition from pre-retirement accumulation phase to the post-retirement distribution phase is the most critical time for investor wealth and well-being because account balances are at their highest. Anything that jeopardizes asset value during the 5 years on either side of retirement is a risk that plan participants should not be taking. Plan participants and sponsors should recognize the

need to protect asset value during this critical transition phase. Witness the unfortunate calamity experienced by 2010 investors last year.

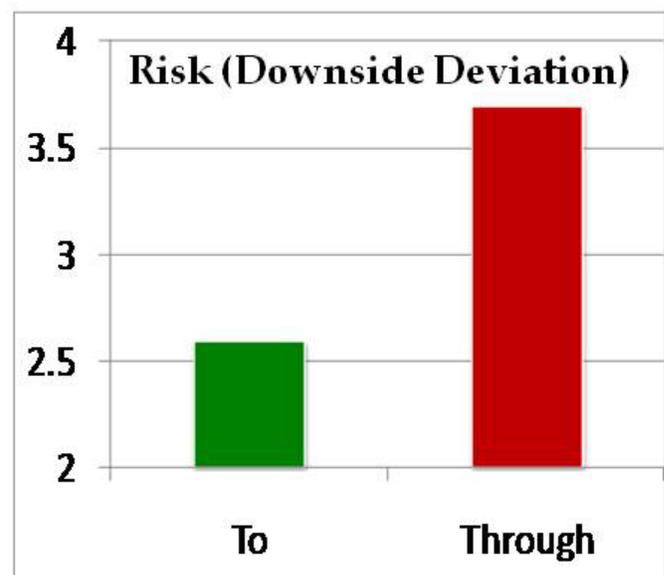
Accordingly, we've conducted a similar analysis focused on just the last 10 years of the glide path. There are 74 such 10-year periods summarized in the next exhibit.

To versus Through Glide Path Comparisons 1926-2008 (74 10-year periods)

(\$1,000 initial balance, plus \$1k/yr increasing at 3%/yr)



Through is 6% Richer

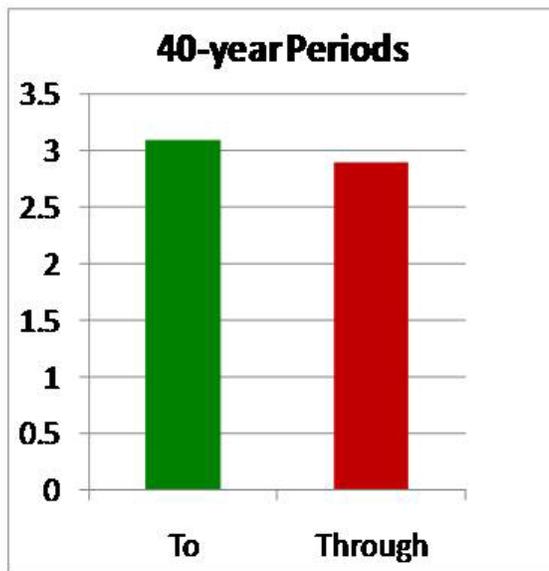


Through is 39% Riskier

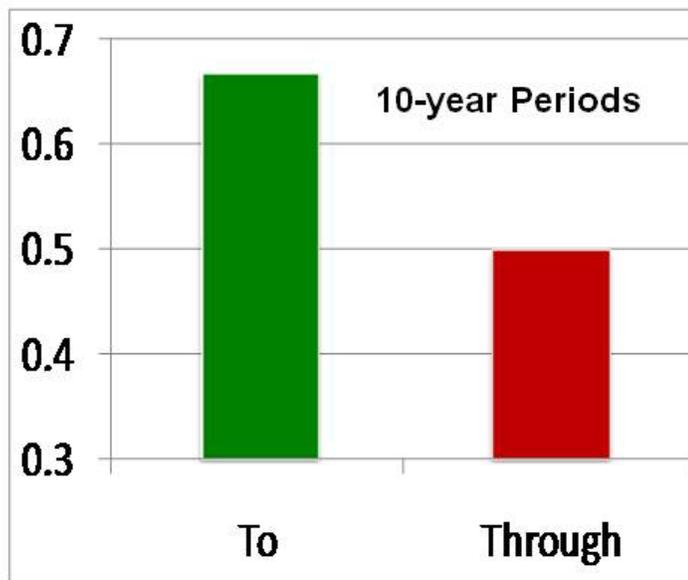
Now we see a huge difference in risk, with the **THROUGH** approach taking 39% more risk than the **TO** path, although it does deliver marginally higher ending wealth.

Another way to compare risk and reward is by calculating the ratio of ending wealth to downside risk, as presented in the next exhibit.

Reward-to-Risk Ratios 1926-2008



To is 7% Higher



To is 34% Higher

As you can see, the reward-to-risk is about the same for the complete 40-year glide path, but **TO** funds dominate over the critical last 10 years of the path. So now you know the risk and reward considerations in your choice between **TO** and **THROUGH**.

Plan sponsors need to drive this bus. Until now, the **THROUGH** solution has been sold because it provides the fund provider with an extended revenue stream. Consequently, **THROUGH** funds appear to be the only game in town, but this is simply not true – there are indeed **TO** funds. It comes as no surprise that there are choices in this relatively new product offering. The good news is that one of the critical choices is straightforward: **THROUGH** or **TO**.

Reference

Surz, Ronald J., "Should Investors Hold More Equities Near Retirement, or Less?"
Advisor Perspectives, August 2009

http://www.advisorperspectives.com/newsletters09/Should_Investors_Hold_More_Equities_Near_Retirement.php