Target-Date Retirement Funds
A Blueprint for Effective Portfolio Construction

- Target-date funds are helping to address the retirement challenge, but they're not all created equal
- Our research indicates that many target-date funds invest inappropriately—and too conservatively—to build enough wealth for retirement*
- In our view, the keys to success include a higher equity "glide path," diversified investment components, active management and rebalancing

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Mr. Fontaine is director of research for AllianceBernstein's defined contribution business. He is currently researching effective target-date fund construction and the delivery of simple guaranteed retirement income. He is the author of "Target-Date Funds: A Blueprint for Effective Portfolio Construction" and "Target-Date Retirement Funds: Why Design Really Matters". Prior to his current role, Mr. Fontaine was a senior portfolio manager and director of research for the AllianceBernstein Blend Solutions team. Previous to joining the Blend team, Mr. Fontaine was a senior quantitative analyst responsible for the research and development of US Structured Equity products, as well as the design of the firm's global equity portfolio analytics systems. Previous to joining the firm in 1999, Mr. Fontaine was a quantitative analyst at Tudor Investment Corporation. Mr. Fontaine earned a BS, cum laude, in both Mathematics and Computer Science from the University of Wisconsin-Madison in 1988 and a Ph.D. in Computer Science from the University of Pennsylvania in 1993. He has earned the Global Association of Risk Professionals Financial Risk Manager certification and is a CFA Charter holder.

*AllianceBernstein research, 2007

Targeting a Growing Retirement Challenge

The growth in defined contribution plans has made many participants responsible for investing for their own retirement. Target-date funds can help—if they're designed effectively.

In recent years, defined contribution (DC) plans have moved front and center as the primary source of retirement savings for many Americans. Individuals also have become increasingly responsible for navigating their way to a secure retirement.

This change has exposed some challenges—participation rates, contribution rates and savings levels remain stubbornly low. The likely problem: investors may not know how much money they will need to fund their retirements, and they're overwhelmed by a dizzying array of choices.

Plan Sponsors Are Trying to Help

Plan sponsors have been working hard to tackle the problems—here's what they told us about their goals*:

- 52% of plan sponsors said it was important to increase plan participation
- 73% said it was important to increase employees' savings levels
- 77% said it was important to help employees make better investment decisions

Participants' choices—both good and bad—have a major impact on their ability to save. And from an investment standpoint, bad choices are still far too common among participants overwhelmed by paperwork, choices and indecision.

Target-Date Funds: A Step in the Right Direction

Target-date funds are an increasingly popular and simple solution for 401(k) participants but not every target-date fund has what it takes to succeed.

We believe many of these funds invest too conservatively and don't diversify enough—these flaws can have dire consequences for participants, who may be more likely to run out of money in retirement.

In this report, we'll take a closer look at the attributes we believe form the foundation for a successful target-date retirement fund.

Effective target-date funds help tackle the retirement challenge, but what makes a target-date fund effective?

* 2007 AllianceBernstein research of 1,200 plan sponsors

The Many Faces of Retirement Risk

Participants face a changing landscape of risk as they move toward—and through—retirement. Target-date funds must take a dynamic approach to addressing these risks.

Retirement Risks: The Big Four

The first step in designing an effective target-date fund is to understand the types of risk investors face. We've identified four key risks: market, inflation, shortfall and longevity.

Market risk is the possibility that a steep or extended market downturn will create losses that erode investors' hard-earned savings.

Inflation risk is the tendency of prices to rise over time, thus eating away at investors' real standard of living.

Shortfall risk arises if investors don't save enough, invest too conservatively or don't diversify appropriately—flaws that can cause them to come up short in their retirement savings.

And there's longevity risk—the possibility that retirees outlive the savings they've accumulated. This probability is rising as people are, on average, living longer.

Balancing Retirement Risks

Investors don't have the luxury of facing these risks one at a time—they face an ever-changing combination of risks.

For example, their investment returns in retirement may or may not support the real spending they need to maintain their lifestyle. They may be forced to withdraw, or even deplete, their savings. In other words, they face market, longevity and inflation risk all at once.

The best way to take on these risks is to invest fully in solutions—like target-date funds—that balance short-term downside protection against the potential long-term impact of lower investment returns. Later in this piece, we'll explore how risks change over investors' lifetimes—and how target-date funds should adjust.

Risk Trade-offs in Retirement Savings: Diversification Across Assets Is Key

Type of Risk	"Safer" Assets	"Riskier" Assets
Market	Cash	Equities
Inflation	Equities, Inflation-Protected Securities	Cash, Regular Bonds
Savings Shortfall	Equities	Cash
Longevity	Equities	Cash

Diversification does not eliminate the risk of loss.
Source: AllianceBernstein

Investors face an ever-changing combination of risks during their lifetimes; target-date funds must balance them dynamically.

The Equity "Glide Path"—A Key to Long-Term Growth

One of the most efficient ways for target-date funds to adjust to changing risks during investors' lives is to change their exposure to equity—the engine of long-term growth.

Many target-date funds don't have enough equity exposure, which increases shortfall, inflation and longevity risk. The popular press focuses on the equity allocation at the targeted retirement date, but it's the "glide path" of equity exposure throughout the savings cycle that really matters.

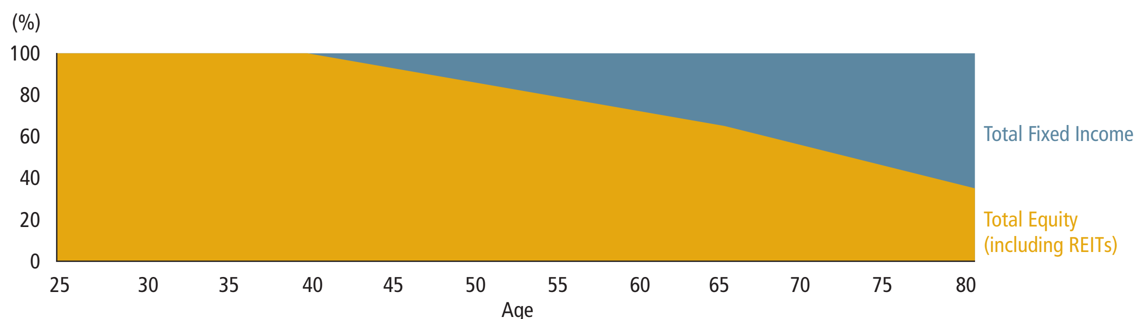
We've found that the most effective glide path contains generally higher equity exposure, especially for younger investors with 30 years until retirement—and maybe another 30 years *in* retirement. Many target-date funds are too conservative with equity—they start reducing their equity exposure too soon, making it harder to build retirement wealth.

While most funds end up with 35 to 50% stock exposure at retirement, we recommend all-equity exposure, including global real estate investment trusts (REITs) through age 40. Equity exposure then declines to 65% at retirement and stabilizes at 35% around age 80.

At each point of the glide path, equity exposure should be well diversified: U.S. large-cap growth and value stocks; international growth and value stocks; small- and mid-cap growth and value stocks; and global REITs.

Following the Equity Glide Path

Asset Allocation by Participant Age



Source: AllianceBernstein

Higher equity exposure along the retirement-savings "glide path" is a key to building long-term retirement wealth.

The Saving Years: Building a Nest Egg for Retirement

For participants who are working and building wealth for retirement, the goal is clear: maximize the amount of wealth they build during their working years.

To help us analyze target-date funds—and how they should adapt to investors' changing needs—we defined four different life-cycle phases: young savers, midlife savers, young retirees and senior retirees.

Here, we look at the two phases that define the saving years.

Young Savers: Maximizing Returns

Young savers are just starting out. They don't have much in the way of assets, but they have very long investment horizons—a lifetime of earnings potential and contributions to their retirement savings. We refer to this potential as "human capital." Their contributions will be steady—like the income of a bond—and will form the foundation of their retirement savings.

The goal for young savers is simple: to maximize returns on their relatively small amount of investable assets. Market risk isn't a major factor for young savers because they have little savings to lose and they have time to recover from capital losses. But shortfall risk is critical: to start the ball rolling toward retirement, the target-date fund should pursue high returns with an all-equity portfolio.

Target-date funds must diversify—across asset classes, market caps, styles and geographies.

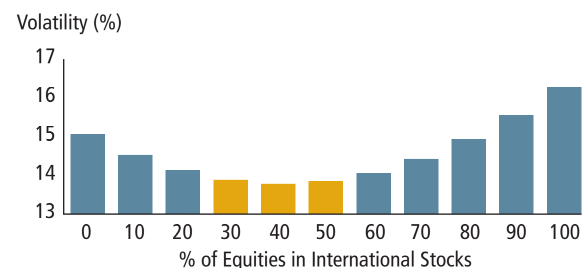
Effective Diversification is the Constant

Effective diversification* should remain a constant goal for target-date funds, even as their allocation changes in response to participants' evolving needs. Stocks should be fully diversified across asset classes, market caps, styles and geographies. For example, our research shows that allocating at least 30% of a stock portfolio to international stocks can be effective at lowering risk and increasing potential returns.

In later years, bonds will grow in importance; they should also be diversified across maturities, sectors and credit quality. Modest exposure to global REITs can further improve risk-adjusted returns, since REITs diversify both traditional stock and bond exposure.

Substantial International Exposure Is Needed to Reduce Volatility

Annualized Risk
1970–2007



Past performance does not guarantee future results.

Through December 31, 2007

U.S. stocks are represented by the S&P 500 Index. International stocks are represented by the MSCI (Morgan Stanley Capital International) EAFE Index. The chart presents various combinations of U.S. and international stocks. Volatility is defined as the annualized standard deviation of portfolio returns for the period from 1970 to 2007. An investor cannot invest directly in an index, whose results are not indicative of any specific investment, including any AllianceBernstein mutual fund.

Source: MSCI, Standard & Poor's and AllianceBernstein

* Diversification does not eliminate the risk of loss.

Midlife Savers: Emphasizing Strong Returns with Less Risk

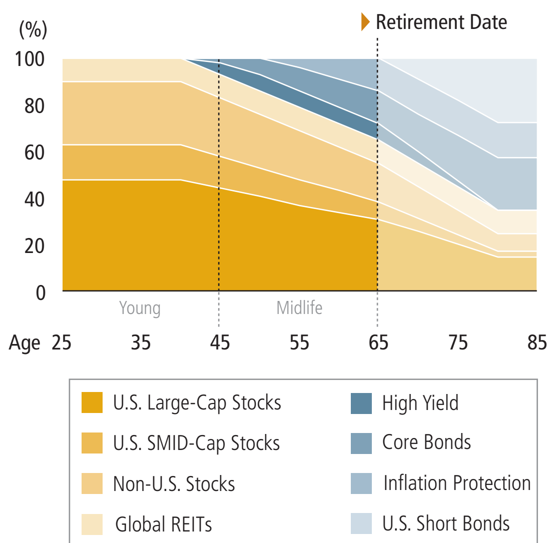
Like young savers, midlife savers will be investing for a long time—perhaps 40 years or more—but midlife savers are different, and the target-date fund's design should adapt to their unique needs.

For midlife savers, shortfall risk goes head-to-head with market risk. In other words, their need to build savings begins to compete with the need to avoid big capital losses.

Midlife savers are in the "sweet spot" of investment opportunity: they still have a long time to earn and invest, and they've built up enough assets to make compounding incredibly powerful. It's an opportunity that shouldn't be missed or misused.

Portfolio Allocations During the Savings Cycle

A Broader Diversified Mix



Source: AllianceBernstein

The Need for Greater Equity Exposure

Midlife savers need to build on their accumulated savings, so higher returns matter much more than when they were young (just as they matter more in early retirement than later in retirement). Thus, maintaining higher equity exposure than in a traditional portfolio becomes important.

We've found that many target-date funds are too conservative during the midlife saver phase. They don't invest enough in equities, which hinders investors' ability to compound their savings. This flaw could cost them hundreds of thousands of dollars by early retirement.

Our research shows that conservative glide paths and our recommended glide path would likely have similar downsides in bad markets, but our glide path would have better outcomes in typical markets and a greater upside in very good markets.

Bonds Join the Portfolio Mix

As midlife savers approach and enter retirement, it becomes harder for them to replace capital losses with future earnings—especially in retirement, when they stop contributing and start withdrawing. In this phase, target-date funds should begin introducing greater stability.

This stability comes from bonds, which help reduce short-term losses that can cause investors to make impulsive and damaging decisions. This is particularly true in equity bear markets, since bonds tend to rise when stocks fall.

The Retirement Years: Making Savings Last

For retirees—both new and senior—the goal is to make retirement savings last as long as possible. Our research shows that slashing equity exposure isn't the way.

New Retirees: Making Savings Last While Reducing Risk

Retirees are no longer earning income, so they'll have to use their accumulated savings to fund any spending. The target-date fund must continue to strike a careful balance between market risk, inflation risk, shortfall risk and longevity risk.

New retirees have already reached age 65, but longevity risk is still a concern. New retirees could have 30 years or more of spending in front of them, so they still need to seek attractive returns. This requires heavier exposure to equities than many target-date funds provide: we recommend 65% total equity exposure (including global REITs) at retirement, declining to about 35% by age 80.

As the equity allocation declines, bond exposure grows and becomes more conservative, with high-yield bonds giving way to short-term bonds and inflation protection.

Our research shows that a higher equity allocation reduces longevity risk, outweighing the added market risk it brings.

Planning for a Longer Life

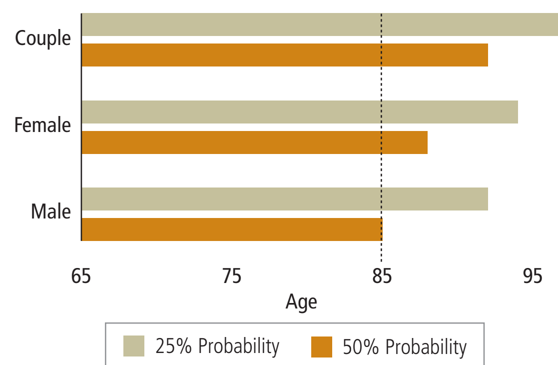
Thirty years may seem like a long time to spend in retirement, but it's a reality: people are living longer.

The American man who reaches age 65 has a 50% chance of living beyond 85 years—and a 25% chance of living beyond 90 years. Women tend to live even longer.

For couples who live to 65, there's a 50% chance that one or both partners will live beyond 92, and there's a 25% chance that one or both of them will live beyond 97.

While longer lives are a blessing, it's critical for target-date funds to prepare for that possibility with appropriate portfolio construction.

Retirees Are Likely to Live Well Past 85 Years



Data for couples show likely life span for at least one member of the couple.
Source: 2000 Annuity Table

Senior Retirees: Preserve and Protect

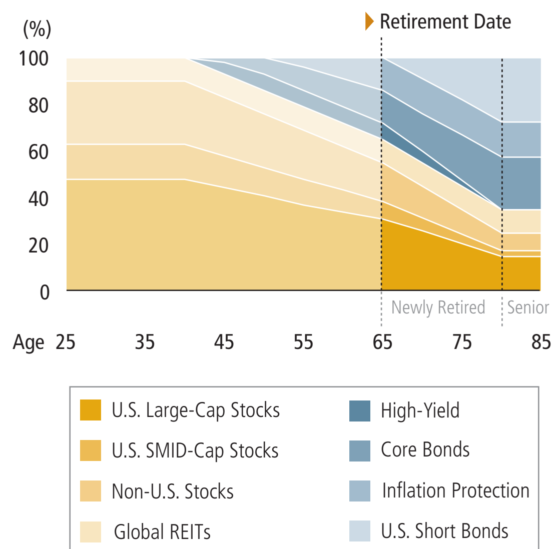
As participants move deeper into retirement, their investment horizon gradually shrinks, and they face the growing possibility that they'll run out of savings.

Market risk grows increasingly important: senior retirees have fewer years remaining in which to compound market gains or recover from market losses, so they need more protection than younger participants do.

Of course, senior retirees still need to earn a positive real rate of return on their assets, but it isn't worth risking a market downturn. The target-date fund should seek to limit losses while still generating high enough returns to preserve retirees' real purchasing power. Equity exposure should continue to decline until it reaches a low of 35% (including global REITs) at age 80. The overall portfolio composition should then remain stable through the rest of participants' retirement years.

Portfolio Allocations During the Retirement Phase

A Broader Diversified Mix



Source: AllianceBernstein

The glide path should level off later in retirement, focusing on preserving real purchasing power.

Enhancing Portfolio Returns

The stakes are high for participants saving for retirement, and the basic design of a target-date fund can make a big difference. Are there other elements with the potential to enhance portfolio returns?

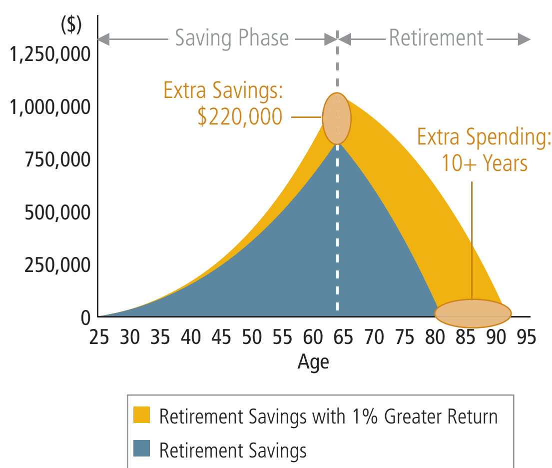
The High Stakes of Wealth-Building

When working to build wealth over the long term, getting it right can make the difference between enjoying a comfortable retirement and running out of money.

Our research shows that improving a target-date fund's performance by even an extra 1% per year could translate into an extra 10 years of spending in retirement, given some fairly reasonable assumptions.

The Potential Impact of Better Performance

10 Extra Years of Spending



Past performance is no guarantee of future results.

Results are simulated. The saving phase simulates an investor with a salary of $45,000 at age 25, linearly increasing to $85,000 by age 65, making yearly contributions to a retirement plan of 6% of salary at age 25, increasing by 0.5% per year to a maximum of 10% and with a 50% company matching contribution up to the first 6% of salary. In retirement, $63,750 (75% of final salary) is deducted at the beginning of each year. The blue area shows ending savings with an investment return of 9% assumed at age 25, linearly decreasing to 6% at age 80 and remaining constant thereafter. Inflation is assumed to be a constant 3%. The yellow area assumes 1% greater return each year. All amounts are in present-day dollars.

Source: AllianceBernstein

It's impossible to overstate how important basic asset allocation is to improving returns, but target-date funds may add value in other ways. Active management is one of them.

The Importance of Active Management

There's really no such thing as a "passive" target-date fund, even when its components are managed passively, because setting the glide path and choosing portfolio components are active decisions.

It's hard to identify skilled active managers; passive management would bring lower fees and be more likely to post benchmark-like returns. But we believe firmly that the potential benefits of active management make it worth the effort.

Active equity managers typically try to beat their benchmarks by 2 to 3% before fees; active bond managers target outperformance between 0.5 and 1%. If skilled management can add even 1% net of fees versus a passive approach, the impact on investors' savings over time could be enormous—and fund more than 10 extra years of spending.

The multi-asset-class structure of target-date funds provides the perfect framework to combine skilled active managers with negatively correlated excess returns. This combination also helps offset the unique risks of each component.

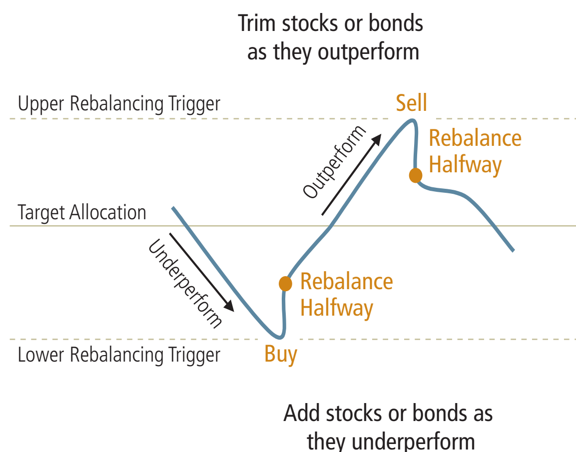
Staying on Track with Rebalancing

Target-date funds feature a diverse collection of asset classes that tend to perform differently. At any given time, some will lead and others will trail; target-date funds must be kept on track by rebalancing systematically.

Instead of rebalancing quarterly or monthly, we recommend doing it when the portfolio drifts far enough to reach "trigger points." These trigger points indicate when the risk reduction from rebalancing is worth more than it costs to implement.

New cash flows into a portfolio also offer opportunities to maintain its target allocation and avoid rebalancing events. This approach not only helps reduce risk, it can also lead to greater return potential. It avoids the transaction costs generated by rebalancing—or by adjusting the allocations as the portfolio moves down the glide path.

How Trigger-Point Rebalancing Works



Benchmarks: Under Construction

The traditional way to evaluate a target-date fund's returns is to compare them with a stated benchmark or peer universe. In the case of target-date funds, however, this method leaves a lot to be desired. Unless a fund has the same allocation as its benchmark or policies similar to its peer group, who's to say if asset allocation or security selection drove performance?

We believe that comparing a fund's net-of-fees returns with those of other target-date funds of the same "vintage" gives the clearest picture. Comparing a 2045 fund to other 2045 funds, for example, provides a more balanced measurement of its effectiveness. We believe this method will eventually become standard, but for now target-date performance evaluation remains a work in progress.

Instead of rebalancing quarterly or monthly, we recommend rebalancing when the portfolio drifts far enough to reach "trigger points."

A Broader Perspective

Target-date funds are helping plan sponsors address the retirement challenge. But plan sponsors have other ways to help participants save for retirement.

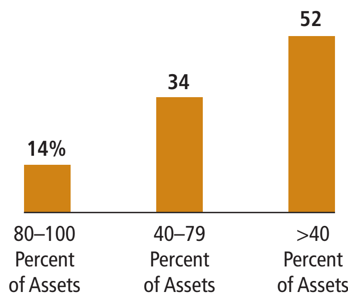
Target-Date Funds: An Important Step

Target-date retirement funds are an important step toward helping investors take a thoughtful and reasonable approach to retirement saving.

Sound investment options play a critical role in defined contribution plans, and effective target-date funds offer many benefits—we recommend that plan sponsors make target-date funds the default investment choice in their plans.

Still Work to Do: Few Participants' Choose Target-Date Funds for Their Main Investment

Percentage of Participants' Assets in Target-Date Retirement Funds



Source: AllianceBernstein 2008

Automation Is Critical

But there's a limit to the effectiveness of target-date funds.

If participants don't contribute enough or don't participate at all, they'll handicap their retirement-savings efforts. Automatic enrollment and contribution systems can boost participation levels and participants' contribution levels.

We applaud plan sponsors' recent efforts to encourage increased participation and contribution rates. We hope more of them adopt auto-enrollment and auto-escalation contribution systems and make participants opt out instead of opt in.

Automation may be one of the most important ways for plan sponsors to position participants for financial security in retirement.

When it comes to participants saving for retirement, automation may be their greatest ally.

A Targeted Communications Plan

Target-date funds are designed to help investors by automating many of the investment decisions that participants struggle with. But plan sponsors' efforts shouldn't stop when participants are in the plan, contributing an adequate amount and investing in a target-date fund. In our view, communications are a valuable link—reinforcing timeless investment principles, managing expectations and explaining the benefits of target-date funds.

We believe a two-pronged approach is most effective. Target-date communications materials should begin with simple and clear information for less confident investors and follow with detailed content for those who are more confident.

Communicating a Long-Term Perspective

Ongoing communications such as quarterly reports should be created with the awareness that participants tend to react emotionally, allowing their emotional biases to drive poor choices.

If communications include dramatic headlines about market events or asset-class performance, they can fan these flames. Instead, communications should remind participants that target-date funds are long-term investments. Participants should expect both strong and weak performance—sometimes for periods lasting several years.

In short, target-date fund communications should echo the principles of the funds themselves, providing a balanced, thoughtful and long-term perspective to participants.

In Summary:
What Makes a Target-Date Fund Successful?

Target-date funds should be simple to use and well-designed in order to maximize the likelihood of participants' success. As fiduciaries, plan sponsors should expect and require nothing less.

Plan sponsors should carefully evaluate funds and document their investment processes to identify the attributes we believe will help foster success.

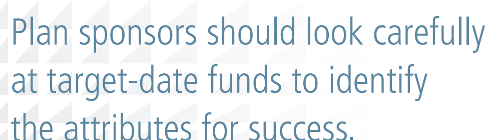
A dynamic approach to risk management throughout the savings and retirement cycle. Risks don't remain static throughout participants' lives. Effective target-date funds carefully assess the different risks of various life phases and deliver an appropriate asset allocation throughout participants' life cycles.

Substantial equity exposure, even into early retirement. Participants need substantial equity allocations throughout their saving years and into early retirement to generate sufficient growth and reduce the risk that they'll outlive their assets.

A high degree of diversification. Diversification across asset classes, styles, market-caps and geographies can reduce the risk of capital losses caused by adverse markets, while at the same time improving the consistency of returns.

Effective active management. The diversified target-date fund provides an ideal framework for combining skilled active managers. If effective active management and efficient rebalancing produce even modest excess returns, the long-term impact can be impressive.

A thoughtful and targeted communications plan. Communication is crucial to building enrollment and helping participants invest wisely. A combination of simple up-front messages and detailed information can keep participants informed and help plans become more successful.



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- Exploring the opportunities and risks of the world's capital markets and the innovations that can reshape them
- Helping investors overcome their emotions and keep their portfolios on track
- Defining the importance of investment planning and portfolio construction in determining investment success
- Providing tools to help plan sponsors educate and engage their plan participants

We've designed AllianceBernstein Research Insights as a foundation to help you serve your plan participants. Speak to your AllianceBernstein relationship team to find out how we can help you.

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