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Feature Story

Market turmoil driving evolution of target-date funds closer to defined benefit pension design

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Target-date retirement portfolios have gained wide popularity as a 401(k) plan qualified default investment alternative just as financial markets have entered a period of extreme volatility. Like nearly all investments, target-date portfolios — especially those intended for the youngest participants with the most distant retirement horizon and thus the highest equity allocation — recently have registered sharply negative returns. Consulting firm Greenwich Research has noted that some employees were defaulted into target-date portfolios just as the stock market was beginning to drop. According to the firm, from 2007-2008, the proportion of plan sponsors using money-market or stable-value funds as their default option dropped from 35% to 19%, while the percentage using target-date portfolios rose from 35% to 53%. "It's like a bad Greek tragedy," lamented a Greenwich consultant. While it's easy to be swept up in the drama of the moment, today's stormy investment climate calls for all the actors — particularly plan sponsors — to review critically not only Act I, but also to look ahead to the rest of the play. To do so, they must regain some perspective on the present and consider all of their defined contribution plan investment management alternatives to assure that they are indeed equipping employees for a retirement that will be anything but tragic.

ACCIDENTAL INVESTORS

Recall that target-date portfolios were devised as a logical response to the recognition that most employees, despite extensive investment education campaigns by plan sponsors, were struggling to allocate their salary deferrals in a manner appropriate to their investment time-horizons.

AllianceBernstein research from August 2006 reveals that about two-thirds of plan participants are, in effect, "accidental investors," who describe themselves as incapable of or unwilling to make investment choices. Target-date portfolios can be attractive for both these accidental investors and their more confident colleagues, because target-date portfolios offer a premixed asset-allocation strategy designed by investment professionals that automatically adjusts as participants age.

Recognizing this fact, the Department of Labor designated target-date portfolios as QDIAs in 2007, thereby offering plan sponsors protection under the Pension Protection Act of 2006 by insulating fiduciaries from liability for employees' investment losses. With the strong appeal of target-date portfolios to participants and sponsors alike, it is clear why many plans have made target-date portfolios their default options, replacing stable-value and money-market funds, which are only QDIAs for the first 120 days after a participant is automatically enrolled.

While target-date portfolios are increasingly accepted as more suitable investments than money-market funds for young participants, market declines over the past year have left many older target-date portfolio investors with less savings, prompting some to question whether target-date portfolios exposed near-retirement participants to too much equity risk.

Yet according to analysis published in February by the Employee Benefit Research Institute spanning more than 21 million 401(k) plan participants, "nearly 1 in 4 between ages 56 and 65 had more than 90% of their account balances in equities at year-end 2007... Had all 401(k) participants been in the average target-date fund at the end of 2007, 40% of the participants would have had at least a 20% decrease in their equity concentrations, and consequently, might have mitigated their losses, sometimes to an appreciable extent."

Thomas J. Fontaine

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THE EVOLVING ROLE OF TARGET-DATE PORTFOLIOS

Fundamentally, the aim of DC plans is to help participants achieve retirement security by supplementing Social Security income with an additional income source, a role once prominently played by defined benefit plans. While such plans are no longer broadly available, DC plan sponsors are increasingly seeking to replicate the core advantages of the traditional defined benefit plan design and management within the legal framework of their DC plans.

Those advantages include effortless employee participation; expert investment design; lower fees; flexible, best-in-class investment management; and, most important, secure lifetime retirement income. With effortless participation achieved through auto-enrollment, the remaining DB-like attributes must be provided through the plan's default option — and innovations are moving target-date portfolios closer to replicating the best features of the once-ubiquitous DB plan.

Yet choosing a target-date portfolio can be daunting: Sponsors are confronted with an enormous choice of offerings that are time-consuming to assess. They may naturally gravitate to simple "closed architecture" structures in which a single manager determines the asset allocation and manages all the underlying components, often delivered in a mutual fund. Unfortunately, such closed architecture funds do not replicate advantageous DB-like features: the plan sponsor cannot change the asset allocation or the underlying investment components, even if a component is underperforming.

Closed-architecture target-date portfolios may be the only choice for smaller plans. But larger plans have sound reasons to consider open-architecture portfolios. Lower fees can likely be achieved through "collective investment trusts" and, importantly, the sponsor retains control. The result is a potentially superior offering for participants and enhanced fiduciary strength for the sponsor.

CUSTOMIZATION TO MEET PLAN NEEDS

The control afforded by open architecture enables sponsors to choose any combination of passive and actively managed component strategies. For example, a plan sponsor could use an index fund for the large capitalization domestic-stock component, use one or more active managers for small-cap stock and perhaps split the international stocks and bond portfolios equally among passive and active strategies.

Open architecture therefore also allows sponsors to replace an underperforming strategy seamlessly, without disrupting plan participants. Sponsors concerned about complexity can take solace in the fact that the operational platform that some service providers have developed allows the plan sponsor to create the initial customized portfolios very easily while preserving the ability to make ongoing changes with minimal effort.

Finally, open-architecture portfolios allow for a customized "glide path" – the pattern of each portfolio's transition from a more aggressive, equity-weighted posture, to a higher concentration of fixed-income securities. Providers work with sponsors to devise a suitable glide path and can serve as fiduciaries, providing a valuable benefit to participants and sponsors alike.

Seth J. Masters

Philosophical differences are likely to dissipate as providers innovate to deliver the most valued aspect of a DB plan: simple lifetime guaranteed income.

PHILOSOPHICAL VARIATIONS

Recently, much attention has been focused on distinctions between the glide paths of the target portfolios offered by different fund providers. A root cause of differences is a lack of consensus in the purpose of target-date portfolios.

One provider of target-date analytical tools suggests that the goal is to minimize participants' exposure to loss by retirement age, moving to 100% cash or bonds. Their conviction is that employees at that stage will reset their asset allocations based on their risk tolerance and unique personal financial circumstances.

Many target-date fund managers believe in taking investors to and through retirement, and have based their designs on the fact that most healthy employees

will live at least 25 years into retirement and need significant equity exposure, even after the target date is reached, in order to prolong spending and protect against inflation.

A historical perspective provides ammunition to those — even in today's bear market — urging a "stay-the-course" exposure to equities.

An analysis by AllianceBernstein compared the results of all-cash versus a 60/40 stock/bond portfolio mix for 53 consecutive 30-year periods, including the Great Depression, beginning in 1926.

The "test" was whether a 5% annual withdrawal rate from those two alternative portfolio mixes would have resulted in the portfolio's depletion prior to the end of each 30-year period. The result: The 60/40-based portfolio was never depleted, but the all-cash strategy resulted in portfolio depletion in 49% of the 30-year periods.

And the results were even more striking when inflation was added to the equation: When annual portfolio withdrawals were increased each year to maintain purchasing power lost to each year's inflation rate, the all-cash portfolio never lasted 30 years, but the 60/40 mix survived 74% of the 30-year periods measured.

The analysis also concluded that substituting bonds for cash would have done little to improve the portfolio's long-term durability.

While investing in cash or bonds feels safer, the longer-term risk of asset depletion is not apparent in the short term and is frequently overlooked.

THE CLOSING ACT: GUARANTEED RETIREMENT INCOME

Philosophical differences are likely to dissipate as providers innovate to deliver the most valued aspect of a DB plan: simple lifetime guaranteed income. The concept is to incorporate cost-effective insurance company-backed guarantees that automatically secure retirement income while preserving the best attributes of a DC plan, including control of assets.

Under this approach, as employees draw nearer to retirement, the glide path of their target-date portfolio not only becomes more conservative, but begins incorporating an increasing stake in an insurer-backed guaranteed lifetime withdrawal benefit.

That insurance feature guarantees that a specified percentage of the portfolio's value at retirement can be withdrawn annually for the duration of that employee's life.

Guaranteed income can increase in good markets but does not decline in bad markets.

If the portfolio no longer supports the specified withdrawal rate, the insurance protection bridges the gap.

Unfortunately, none of the recent innovations to target-date portfolios will restore employees' equity portfolios to their precrash levels overnight.

But by adopting these enhancements now, plan sponsors can go a long way toward providing employees the kind of future retirement-income security unknown since the heyday of the defined benefit pension. ***–E.B.N.***

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For the cash versus 60/40 portfolio analysis: US stock returns are represented by the S&P 500 sourced from Ibbotson until 1969, Compustat from 1970-2006 and S&P thereafter; US bond returns by five-year Treasuries sourced from Ibbotson through January 1962, the Federal Reserve from February 1962-December 1969, CRSP/TPA from 1970–1972, by Lehman Intermediate Gov/Corp from 1973–1975 sourced from Lehman Brothers, and by the Lehman Aggregate sourced from Lehman Brothers thereafter; and cash returns are three-month Treasuries from Ibbotson through 1962, the Federal Reserve from 1963–1969, CRSP/TPA from January 1970–August 2007, and Citigroup, thereafter. Inflation is represented by the Consumer Price Index sourced from Ibbotson from 1926–1947 and the Bureau of Labor Statistics, thereafter. Past performance does not guarantee future results. Investors cannot invest directly in an index and its results are not indicative of any AllianceBernstein product.

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