Why target date funds are going mainstream

We believe target date funds (TDFs) could soon become the rule rather than the exception in pensions. Industry forecasts suggest that, by 2018, over six million of us will be contributing around £11 billion to workplace pensions*, or nearly triple the current level. Our figures suggest that as much as half of that could end up in TDF defaults.

Even so, there remains confusion over what TDFs are and why they are any better than the competition. That's a shame, because both the principles behind TDFs and their implementation are simple for members, employers and trustees, while providing what we believe are superior outcomes.

So what do they offer members?

Quite simply, a fund for life. An individual who joins a scheme using TDFs as its default will be put into a fund with a 'target date' which covers the retirement window when they might expect to retire. So a 25-year-old looking forward to retiring at 65 would start saving in a fund that included the year 2053, e.g. the Retirement Strategies 2051-2053 fund. All being well, there is nothing more they need do until they retire, beyond making sure that they keep saving enough.

But this simplicity is deceptive. It would be negligent indeed for any scheme to allow a member's investment approach to languish unchanged for what could be 40 years or more of saving and investing. Research shows that a member's age is the biggest single factor in determining the returns they need to seek and the risks they need to run at any stage during this savings journey. So, in a TDF, the investment strategy is proactively managed to adjust to the age of the member as they grow older.

The result is an asset allocation 'glidepath' that evolves with the member and is proactively managed throughout their savings journey. In the early years, when they need the power of equity markets to boost often modest savings, the fund will be predominantly invested in shares. In mid-life, when a member's need for returns and ability to absorb losses typically move into greater balance, bonds and other diversifying assets will take on a bigger role. By the time they are close to retiring, and can take fewer risks with their savings, bonds will predominate in the portfolio. And because our approach uses open architecture, we can accommodate the best investment ideas from whatever source at any stage. All these asset adjustments – and indeed any necessary changes of managers or administrators – happen within the one fund. As a result, members don't have to be involved, vastly simplifying communications.

But while the long-term asset allocation is vital, it is also important to minimise short-term volatility if members are to rest easy at night. That's why we use dynamic asset allocation tools to tactically adjust strategic allocations to current markets. Moreover, to align our interests with members – not to mention clients and trustees – our TDFs hand responsibility for the asset allocation to a manager, making him or her accountable for the fund meeting its objectives. This vastly improves governance as it clearly separates management from oversight of the strategy, which of course remains the responsibility of trustees and/or employers.

Our approach also builds in flexibility, which is seldom more necessary than at the end of a working life. So, instead of aiming for an unrealistically precise retirement date, TDFs point towards a retirement 'window'. This allows people discretion over when and how they take an income, whether by annuity, drawdown or a mix of the two.

We think these features give TDFs the edge over lifestyle funds, the current default offering of choice. While lifestyle provides some measure of de-risking in the crucial run-up to retirement, it is often too rigid to meet the needs of today's pension market. Portfolio decisions are often made only with the benefit of hindsight. And they can often only be made through the buying and selling of individual funds in each member's account, causing upheaval to members and increasing the possibility of sometimes expensive mistakes.

We think that TDFs avoid much of this aggravation. And not just for members. Their design and flexibility also make life much simpler for employers and trustees. So, while some people might think we are being over-optimistic about the future of TDFs, we think their features speak for themselves. Simplicity, flexibility and, ultimately, performance potential mean that they should very soon become an established part of the mainstream.

Tim Banks
Head of Client Relations
Pension Strategies Group
AllianceBernstein

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* *Office of Fair Trading*

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