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Lifestyle vs. Target Date funds

1. What are the key differences between lifestyle and target date funds?

Either approach can be used to provide the required default investment strategy for a defined contribution scheme.

A target date fund (TDF) is an age-based multi-asset fund designed to manage risk throughout the savings journey. Members are typically defaulted into (or choose) the fund with the retirement window that is the closest to their approximate retirement age e.g. the 2032–2034 Retirement Fund. The fund is built using any number of component subfunds.

A lifestyle strategy is a pre-programmed series of trades that rotate each individual member through various investment components (fixed income, equities etc.) as they get older, to a specific date in time designed to match the member's retirement expectation.

We believe TDFs are different from lifestyle strategies as they provide stronger governance for investors, greater underlying sophistication of investment thinking, more robust risk management, the potential for better performance and more simplicity for both members and employers.

2. What approach do you believe is better and why?

As the UK's largest provider of flexible TDFs, we believe the answer is simple.

The clearest difference is that TDF investment default strategies are pro-actively managed, with the fund manager responsible for the daily management of the funds in line with the client's objectives. Lifestyle strategies, in contrast, are an automated programme of trades, which our research shows are usually only managed with the benefit of hindsight. Therefore, TDFs are able to act more intelligently in anticipation of future events: such as market conditions, new legislation, tighter regulations or with a view to the future investment outlook.

A more proactive and sophisticated investment approach goes hand in hand with a more robust approach to risk management. Looking at how we do this ourselves, we use dynamic asset allocation tools to minimise short-term volatility and adjust strategic allocations depending on market conditions. The way TDFs review asset allocation dynamically is a more nuanced and effective way of managing a fund on its glidepath towards an investor's retirement. The mechanistic approach of lifestyle funds takes no heed of market conditions – rather like flying a plane into a thunderstorm while looking in the rear-view mirror. Because TDFs are managed by a human being – who instead (to continue the analogy) looks through the front windscreen, the 'pilot' can manoeuvre the vehicle to avoid any thunderstorm they see coming.

3. What features should schemes look for in such an approach?

We think many of the failures of the traditional approach to default fund design stems from a failure to align the objectives of the scheme and its funds with its members or to genuinely recognise the risks and needs of savers.

We believe that a successful investment default strategy should be built to reflect the client's investment objectives, and that the default should be reviewed against the objectives on a regular basis. The strategy needs to be robust to an individual's changing needs throughout the savings journey.

The default should be pro-actively managed on a daily basis within the set parameters, and should allow for updating with minimal disruption (cost and confusion) to members. It should be able to use the best investment ideas irrespective of where they come from, within an open-architecture framework.

From an investment standpoint you should look for good diversification, embedded dynamic asset allocation and, of course, value for money.

4. What key issues should trustees/plan sponsors consider when deciding on a strategy?

When deciding on an investment strategy, the fiduciary should decide what is appropriate for their members and model the potential outcomes from the intended solution. This provides a clear audit trail against which to judge the strategy's performance.

There should be clearly delineated roles and responsibilities in setting and then managing the default investment strategy. Trustees set objectives, and a professional manages the strategy, with the monitoring carried out by the trustees. This governance model is rarely used today.

The plan sponsors/trustees should consider the longevity of the solution put in place and how easy through time it is to change this. Typically with defined contribution schemes, the more precise the investment design the more inaccurate it is likely to be. Lifestyle funds are a good example of this, where the strategy runs to a specific day – which is unlikely to be correct as individuals rarely know when they will retire!

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