Target Date Funds: will the UK follow the American revolution?

Regulatory developments in the pensions and advisory markets are prompting a fresh look at age-based multi-asset funds, known as lifecycle or Target Date Funds (TDFs), says **Henry Cobbe, CFA**. As part of a broader move towards packaged investment strategies, investment managers may need to reassess their product offering to become a wealth manager, a fund factory, or both.

WHAT ARE TDFs AND HOW DO THEY WORK?

Target Date Funds are multi-asset funds pioneered in the US in the early 1990s. TDFs do not have guaranteed returns, and are not structured products. They are a "packaged investment strategy" that aim to discard behavioural tendencies that could potentially jeopardise savings objectives, for example: excessive choice, naïve diversification, performance extrapolation, market timing, status quo bias, and asymmetric loss aversion (Benartzi and Thaler 1995, 2001, 2004 and 2007).

In contrast to "static" target-risk funds, target date funds have a "dynamic" risk profile which, in early years at a time when risk capacity is high and volatility is affordable relative to potential returns, allocates more to return-seeking assets (equities) and diversifiers (property, alternative assets). This is to counterbalance the bond-like characteristics of "human capital" represented by future career earnings (Chen, Ibbotson, Milevsky & Zhu 2007). In later years, as risk capacity decreases, TDFs allocate more to capital preservation assets such as cash and bonds. The expected pace of derisking over time is known as a "glidepath", and can be visualised by looking at a snapshot of asset allocations for a range of maturities of target date funds.

Executive summary

- Target Date Funds are gaining increasing traction in the UK DC pensions market as the next generation of default funds, driven by auto-enrolment.
- TDFs are a low-cost lifelong investment strategy packaged to be a simple alternative to those who will not or cannot pay for bespoke advice.
- RDR is creating demand for similar funds for the non-pensions market as intermediaries segment their client base, and investors seek out affordable savings solutions.
- TDFs may force fund managers to decide whether to design and manage packaged strategies, or be commoditised as a provider of constituent funds.

As continuously managed funds with diminishing risk profiles, TDFs are ideally suited as DWP-compliant default pension funds. With auto-enrolment due to commence in the UK in October 2012, take-up of properly designed TDFs, similar to those used by NEST, may increase rapidly.

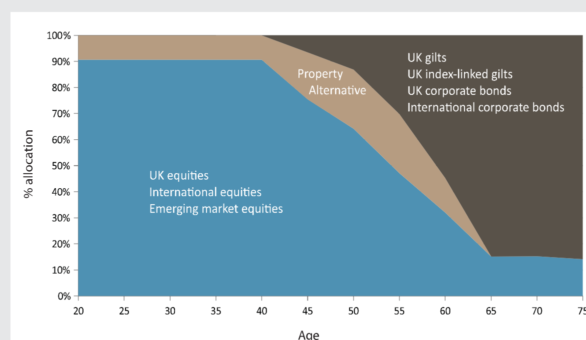
TDFs represent the "fourth generation" default fund, and offers an evolving investment strategy appropriate to a typical investor, within a fund whose objective, or target date, makes them intuitive to understand.

Target Date Funds are continuously managed with regard to market conditions and are therefore an improvement on the automatic derisking techniques of their predecessors.

While TDFs' primary application is age-based funds (for example, someone born in 1970, wishing to retire aged 65 might select a 2035 Target Date Fund), TDFs can use the same underpinning liability-driven investment theory (Chang 2007; Ruth 2007) to build a savings pot towards any future liability such as school or university fees, where the timing and size of the future liability is estimable. This opens up potential applications for TDFs outwith the pensions context.

Glidepaths vary from manager to manager, depending on their investment approach. The main differences are the asset allocation mix of the glidepath, the pace of derisking, and the equity allocation at maturity. Some managers argue for a 0%

Figure 1:
Illustrative TDF strategic allocation



Source: *Elston Consulting, for illustrative purposes only*

Key questions for pension plan sponsors and trustees to ask

QUALITATIVE QUESTIONS TO ASK A MANAGER WHEN CHOOSING A DEFAULT FUND

1. What is the goal of the fund at maturity (annuity purchase, drawdown, income stream)?
2. What is the TER of the fund, and what is the Total Cost of Ownership (all-in cost to investor including TER, platform and advisory fees)?
3. What is the theory underpinning the strategic and tactical asset allocation policies?
4. How does expected return and expected volatility of the fund evolve over time?
5. Is the asset allocation glidepath managed or automated?
6. How is volatility managed?
7. How will the fund overcome: a) inflation risk; b) market downside risk; c) shortfall risk; and d) longevity risk?
8. What are the underlying constituent funds, how are these selected, and what is their impact on TER?
9. What experience does the manager have of designing and running TDFs?
10. How does the default fund measure up to each of the DWP eligibility criteria?

QUANTITATIVE QUESTIONS TO ASK A CONSULTANT WHEN CHOOSING A TDF

1. How do the risk and return graphs look for a TDF vs individual asset classes: is it successful in delivering returns on a risk-adjusted basis?
2. How do different TDF glidepaths compare to get a snapshot of the manager's current investment strategy across all maturities?
3. How has the glidepath changed compared to the previous 3 to 5 years?
4. How does asset allocation compare for TDFs of the same maturity?
5. Will a Monte Carlo simulation illustrate how different funds with different asset allocation glidepaths are likely to perform?

equity allocation at maturity (for example, to fund an annuity purchase), others argue for a moderate 0-20% equity allocation (to fund annuity and/or drawdown). This is known as the "to or through" debate. We believe that the increasing number of choices at retirement aside from annuitisation, plus increasing life-expectancy justify a moderately "flat and conservative" allocation to equities as appropriate insurance against longevity risk (Cohen, Gardner & Fan 2010).

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF A PACKAGED INVESTMENT STRATEGY?

The advantages of TDFs are fourfold:

First, they offer a life-long age-appropriate investment strategy in a single fund. While investors should review their investments regularly regarding suitability, behavioural research suggests that the majority of savings plan participants (for example

Figure 2:
Four generations of default fund

1980s Default v1.0	Equity fund Equity return Equity risk
1990s Default v2.0	Balanced fund Target return Variable risk
2000s Default v3.0	Lifestyle fund Target risk Static risk
2010s Default v4.0	Lifecycle fund Target date Dynamic risk

Source: *Elston Consulting*

Figure 3:
Old and new approaches to derisking the default fund

	OLD Default v3.0 (Lifestyling)	NEW Default v4.0 (Target Date Fund)
Derisking	Traditional	Enhanced
Oversight	None: automated	Constant: managed
Derisking timeframe	Rapid (5-10 years)	Gradual (25 years)
Asset allocation	Heuristic: straight-line	Researched: strategic & tactical
Market conditions	No regard	With regard
Equity allocation at target (retirement)	0%	0-25%
Longevity risk	Higher	Lower
Inflation risk	Higher	Lower
Shortfall risk	Higher	Lower
Drawdown risk	Substantially lower	Partially lower

Source: *Elston Consulting*

in occupational pensions) do not. Financial education is not sufficient to change this behavioural aspect, hence TDFs are designed to correct this, by remaining typically appropriate to a particular age group or target date, all other things being equal.

Second, the asset allocation models are professionally managed, built on both investment theory and fund management practice. This leads to markedly different asset allocation profile compared to traditional balanced funds, and a more scientific approach to risk control.

Third, the pooling together of a peer group's savings for a particular aspiration creates substantial scale benefits, which helps deliver TDFs at similar or lower costs to individually managed traditional funds, while providing, in addition, ongoing fiduciary oversight.

Last, compared to heterogeneous investment strategies devised and reviewed by individual IFAs, TDFs offer a level of design homogeneity that creates some consistency in the market for asset allocation best practice.

The main disadvantage of TDFs is clear and not hidden: not all investors are typical, and many may prefer a bespoke portfolio customised to their specific needs and attitude to risk as regularly reviewed by their investment adviser. However, this comes and will continue to come at a premium cost. Post-RDR the cost of such bespoke services will be made explicit, so the cost-benefit decision of whether to pay for bespoke advice remains a choice investors can and should make for themselves.

For UK regulators, it is helpful that the debate on the pros and cons of TDFs have been extensively rehearsed in the joint SEC/Department of Labor public hearings in 2009, and subsequent SEC recommendations on TDFs in 2010. The conclusions were that while TDFs offered simplicity that made them a popular and welcome investment innovation, managers must give prominent and detailed asset allocation disclosures and reiterate to potential or existing investors the need to consider continually TDFs' appropriateness versus their broader financial circumstances such as risk tolerance, tax position, financial situation, risk tolerance and life expectancy.

"TDFs offer a level of design homogeneity that creates some consistency in the market for asset allocation best practice."

WHY DID THEY TAKE THE US MARKET BY STORM?

The TDF revolution gained momentum when auto-enrolment was introduced with the US Pensions Protection Act 2006. TDF assets grew from $71 billion in 2005 to $340 billion by end of 2010 (Morningstar 2011), or approximately 9% of pension assets (ICI 2011, and our estimates). In terms of popularity for new participants, some 94% of US DC pensions plans now use TDFs as default funds, compared to just 4% in the UK (DCisions, 2011).

The 2006 Act created the necessary legislation for auto-enrolment and safe-harbour investments described by the Department of Labor as "Qualifying Default Investment Alternatives" or QDIAs. Providing a QDIA protects employers from liability of losses suffered by automatically-enrolled

employees. The DoL/EBSA criteria specifically reference target date funds as a suitable QDIA, which explains their near-universal adoption. In the UK, a close reading of the guidance from DWP regarding default funds suggests that in terms of design, eligibility and cost, TDFs could be considered the best practice default option, (in our view). More specifically, TDFs have received a clear endorsement by NEST.

A separate growth driver was that for investors managing their own investments, US legislation allows for "investment guidance". Fund managers or advisers are "guidance providers" offering information and tools for investors to make their own decisions without fiduciary responsibility being assumed, as it is for "investment advice". In the UK, the alternative to full advice is not investment guidance, but "Simplified Advice" the criteria for which has now been set out by the FSA, and could enable similar, but arguably more rigorously regulated direct-to-consumer savings solutions.

Auto-Enrolment, and Simplified Advice provided the regulatory context for TDFs to gain ground in the US. Add to that the attraction of packaging of a complex investment strategy into an apparently simple, intuitively labelled single fund, and the reasons for TDFs rapid success becomes clear.

WILL THE SAME HAPPEN IN THE UK?

Target funds have been present in the UK since at least 2003 but have enjoyed only limited success with an estimated £2 billion AUM. They were introduced at a time when intermediaries were perhaps disincentivised to recommend clients a "life-long fund" that ostensibly negated the intermediary's raison d'etre. So why is market interest in TDFs picking up now?

First, importing the US model of pensions auto-enrolment has created a need for UK-customised default funds, and DWP has provided clear guidance on this.

Second, GPPs are coming under increasing pressure from the FSA to show that their investment alternatives and charging structures compare favourably with NEST. This may create interest in TDFs from GPP providers and the corporate IFAs recommending them.

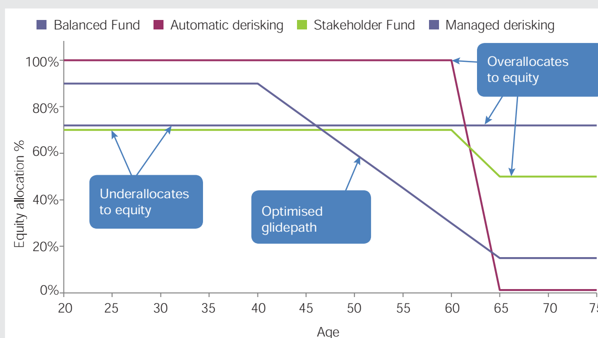
Last, the Retail Distribution Review is bringing into focus the true cost (to consumer and intermediary alike) of servicing smaller investors on an advised basis. In the absence of trail commission payments, the estimated cost of providing full advice at £670 is beyond the reach of 67% of the population (ABI, 2010). Thus full advice is proportionately expensive or even unaffordable to anyone with less than £45,000 to invest (as cost of advice would represent >1.50% ad valorem). Hence the expectation that RDR will drive the consolidation of the IFA market, and steer smaller clients towards "Simplified Advice" or "Execution-Only" offerings. RDR will therefore force IFAs to consider low-cost options for managing the long-tail of their back book.

Other TDF applications could include use as investment solutions for legacy insurance accounts; smaller discretionary or educational trusts; workplace savings schemes and ISA/Junior ISA accounts. Target date funds could therefore have a broader role to play in the new market structure post-RDR outwith the pensions space.

DO FUND FACTORIES NEED TO BECOME WEALTH MANAGERS TO SURVIVE?

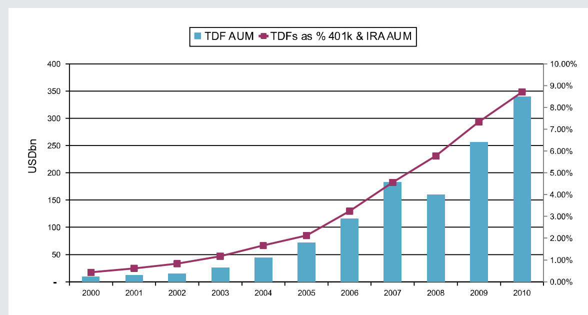
Target date funds rightly focus on active asset allocation, given that it explains 90% of the variability of a fund's returns over time, and 100% of the level of return (Ibbotson and Kaplan 2000; Xiong, Ibbotson, Idzorek and Chen 2010). This makes asset allocation the most important determinant of returns. It is

Figure 4:
TDF glidepath vs traditional portfolio strategies



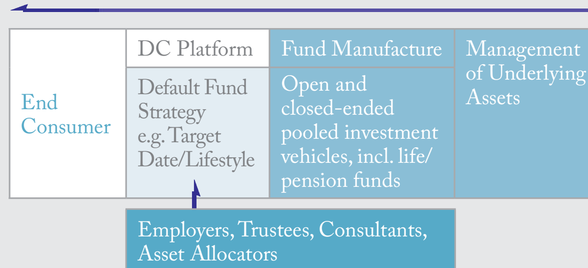
Source: *Elston Consulting estimates, for illustrative purposes only*

Figure 5:
TDF glidepath vs traditional portfolio strategies (US)



Source: *Morningstar, ICI, Elston Consulting estimates*

Figure 6:
Potential opportunities in the DC pensions environment



Source: *IMA Annual Review 2009-10*

therefore a paradox that historically asset allocation decisions for advised investors were made by IFAs, who received a smaller share of the overall client fees than the fund managers pursuing the zero sum game of actively managing the constituent funds.

RDR and the advent of packaged investment strategies will change this as asset allocation decisions are professionalised at the fund management level and constituent funds are possibly commoditised. This change will free up IFAs time to offer more holistic financial planning and advice. The anticipated

> "Target date funds could have a broader role to play in the new market structure post-RDR."

evolution in business models should improve savings outcomes for investors, who should benefit from more consistent and optimised portfolio structures, under continuous review.

For packaged investment strategies, with an emphasis on strategic and tactical asset allocation, we expect passive constituent funds to be the most prevalent, to keep TERs to a minimum. Lower TERs reduces the bar for investors hoping to make real returns, net of fees, which is increasingly important in the current era of depressed real returns.

Indeed, a preference for passive constituent funds could drive a shift in the fund management industry itself. The industry could gradually polarise between asset allocating wealth managers or constituent manager fund factories:, tthe former to provide investment strategy, portfolio construction and risk control, and the latter providing active and/or passive constituent funds.

If fund managers already have a comprehensive range of funds, then we expect them to defend their offering by enhancing their multi-asset product, to include target date funds consisting of mainly in-house funds. If fund managers have only a niche range of funds, then they need to decide whether to remain a specialist fund manager, or start offering wealth management solutions in combination with third-party funds. In either case, there will be pressure on fund management houses to adapt their product offering, or risk commoditisation.

CONCLUSION

By combining behavourial finance with optimised portfolio construction, TDFs are designed to deliver rationally managed consistent risk-adjusted returns. The regulatory direction of auto-enrolment, workplace savings and simplified financial products combined with a generation of newly cost-conscious consumers following the implementation of RDR, could drive a similarly rapid UK take up in age-based packaged strategies as has been witnessed in the US. ■

Profile

Henry Cobbe, CFA

Henry Cobbe is a director of Elston Consulting which provides fiduciary support to intermediaries. After graduating with a degree in Russian from the University of Edinburgh, Henry Cobbe has worked as a buy-side equity research analyst for 13 years, at Schroders, Thames River Capital and Nevsky Capital. He became a CFA charterholder in 2004.