TARGET DATE FUNDS
EQUITY EXPOSURE AT
TARGET DATE AND BEYOND
INTRODUCTION

Target date mutual funds operate by changing their asset allocation over time to coincide with a specific year, most often an investor’s expected retirement year. This means that the percentage allocation of equity investments, or riskier investments, decreases as the retirement date approaches, and conversely, the percentage allocation of fixed income and/or money market investments, both considered less risky, increases. In early 2009, Lipper released a study evaluating 2008 prospectuses to determine the equity percentage allocation that target date funds expect to have at their retirement date. The research uncovered a great deal of variation in equity allocation between target dates series, but consensus was 50% equity exposure at the retirement date.¹ An economic downturn has occurred since that paper was published, which caused major losses to investors with money in target date funds. In turn, these losses forced the Securities and Exchange Commission (SEC) to propose rule changes regarding target date fund disclosure. Now, in 2011, the 2009 paper provides a great case study with which to examine results stemming from these changes. In this paper, we will analyze changes in the percentage of equity holdings, and subsequent changes in fund companies’ language in relation to their risk exposure by comparing 2008 prospectuses to 2011 prospectuses. Next, we will examine the “to” versus “through” dichotomy developing in the industry and its impact on equity exposure. Finally, we discuss the impact these findings may have on the contract renewal process.

KEY POINTS:

1. Target date series assets have more than doubled since 2008.

2. Target date series prospectuses have become more specific regarding investor expectations at retirement and contain more warnings about equity exposure than they did three years ago.

3. Overall equity exposure at the retirement date decreased compared to 2008 glidepaths.

4. Equity exposure over the life of target date series can have implications for expenses and performance. For this reason, fund companies and boards of directors may want to consider glidepath comparisons in the contract renewal process.

TARGET DATE FUNDS EQUITY EXPOSURE AT TARGET DATE AND BEYOND

DECEMBER 2011

HISTORY

Target date series have seen tremendous growth in recent years; currently, there are 43 unique open-end target date series. Approximately half of these series began operations in the last five years, with five new series introduced in 2009 and 2010 alone. In 2008, $175.8 billion in assets sat in target date series, which more than doubled to $368.5 billion by October 31, 2011. The top three series dominated the industry, comprising 79% of assets in 2008, and while these same series still dominate the industry they now account for only 62% of target date assets in 2011 (Table 1).

Seeming to contradict this rapid growth, target date funds near retirement experienced severe losses in conjunction with the stock market in 2008. Target date 2010 funds, a mere two years from their retirement date at the time of the economic downturn, experienced dramatic median performance losses near 30%, but showed positive median returns in the years 2009 and 2010. As of 2010 year-end, 2010 target date funds had median annualized ten-year performance of less than 5%, similar to returns an investor would have experienced in a traditional fixed income mutual fund investment—fixed income funds had annualized median returns of 3.97% for the ten-year period ending December 31, 2010.

These significant losses in 2008 prompted the Securities and Exchange Commission (SEC) to propose new nomenclature rules for target date funds along with guidelines regarding disclosure of glidepath information. The SEC recognizes that these rule changes are a result of the losses in 2008 and the increasing significance of target date funds in 401K plans. Per this new proposal, funds would be required to provide detailed disclosure of their asset allocation at the fund’s target date, including a table, chart, or graphic representation of the glidepath. Another aspect of the change would require equity exposure percentages at the retirement date to be included as part of the fund name. Comments in support and opposition of the changes are available on the SEC’s website.

### TABLE 1  TARGET DATE SERIES ASSETS

<table>
<thead>
<tr>
<th>Fund Series</th>
<th>2008 Assets ($ Mil)</th>
<th>2011 Assets ($ Mil)</th>
</tr>
</thead>
<tbody>
<tr>
<td>T Rowe Price Retirement Funds</td>
<td>28,704</td>
<td>62,656</td>
</tr>
<tr>
<td>Fidelity Freedom Funds</td>
<td>74,920</td>
<td>76,050</td>
</tr>
<tr>
<td>Vanguard Target Retirement Funds</td>
<td>35,255</td>
<td>89,659</td>
</tr>
<tr>
<td><strong>Top 3 Series Total</strong></td>
<td><strong>138,879</strong></td>
<td><strong>228,365</strong></td>
</tr>
<tr>
<td><strong>Total Target Date Fund Assets</strong></td>
<td><strong>175,780</strong></td>
<td><strong>368,451</strong></td>
</tr>
</tbody>
</table>

Note: The 2008 assets are as of September 30, and the 2011 assets are as of October 31.

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3 For more information please consult www.sec.gov
“Some degree of variation in equity exposure is expected given varying levels of risk tolerance for investors, and as such, target date fund managers must toe the line between performance returns and risk exposure.”
EQUITY EXPOSURE
In addition to language alterations, the second change considered in this paper involves actual changes to equity exposure at the retirement date. Some degree of variation in equity exposure is expected given varying levels of risk tolerance for investors, and as such, target date fund managers must toe the line between performance returns and risk exposure. However, given the impact of the economic downturn and proposed rule changes by the SEC, fund series may have decreased their equity exposure at the target date as compared to 2008.

Figures 3 and 4 examine this decrease. The data reveals that equity exposure at the retirement date has decreased since 2008, though not by much. The January 2009 paper found that most target date series designated 50% of their allocation at retirement to equity investments (figure 3). This is still the case, as evidenced by the mode data in Figure 4; however, the average has decreased from 43% to 40%. In addition, high and low values both shifted downward 10%, but the overall spread between the high and low has not changed. These subtle differences indicate a shift toward less equity exposure at the retirement date.

Note: The blue hashmarks represent each individual fund series’ equity exposure at the retirement date. The black hashmark represents the average.
"TO" VERSUS "THROUGH"

This final section takes our analysis one step further by examining equity exposure near the end of life, in regards to whether the target date fund is a "to" or "through" fund. First, it is necessary to define "to" and "through" target date funds. For the purpose of this paper, "through" target date funds continue to adjust their equity exposure after the retirement date, while "to" target date funds either do not adjust their equity exposure after the retirement date, or immediately move the assets into their retirement income offering. Examples of a glidepath for a "through" and a "to" fund are featured in Figures 5 and 6—these examples come from actual target date series.

FIGURE 5  "THROUGH" GLIDEPATH

For the purposes of this paper, "though" target date series continue to adjust their equity exposure past the retirement date.

Note: The green portion of this chart represents the series's equity exposure along the proposed glidepath, while the blue portion of this chart represents the series's fixed income exposure along the proposed glidepath.

FIGURE 6  "TO" GLIDEPATH

For the purposes of this paper, "to" target date series stop adjusting their equity exposure at the retirement date or immediately shift the investments to a retirement income fund.

Note: The green portion of this chart represents the series's equity exposure along the proposed glidepath, while the blue portion of this chart represents the series's fixed income exposure along the proposed glidepath.
“TO” VERSUS “THROUGH”

Currently, approximately 65% of target date funds have a “through” structure (Figure 7). It is difficult to compare this to the percentage of “through” funds in 2008 because the disclosure language in 2008 prospectuses was not as clear. Because of the way “through” target date series are designed, we would expect them to have more equity exposure than “to” target date funds. The data supports this expectation (Figures 8 and 9); “through” target date series have an average of 45% equity exposure at the retirement date, compared to 31% equity exposure for “to” target date series.

“Through” target date series compose a majority of the industry of target date funds.

Note: The blue hashmarks represent each individual fund series' equity exposure at the retirement date. The black hashmark represents the average.
CONCLUSION

IMPLICATIONS FOR THE CONTRACT RENEWAL PROCESS
This paper intended to analyze changes resulting from the economic downturn and proposed rule changes on target date series. Warnings about equity exposure increased and actual equity exposure at the retirement date decreased. In addition, on average, “through” target date series have higher equity exposure at the retirement date. Differences in equity exposure across target date series may have implications for the contract renewal process. Lipper offers custom target date glidepath reports detailing exposure over the series. Fund companies and boards of directors may want to consider the glidepath of comparable target date series when examining the expenses and performance of peer funds against their own. Equity funds tend to be more expensive than fixed income funds, and often have differing performance and flows. It can be important for a board to understand how the fund in question lines up with peers when considering the glidepath.
