TARGET DATE LOOKS AFTER DC MEMBERS

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Target Date Looks After DC Members

After years and years, the defined contribution pension plan industry discovered that it couldn't get plan members interested in learning to manage their plans. Many members were going straight into the default fund, usually a money market fund. Pension plan sponsors finally decided they would have to look after the investments for members, but they needed an option that would make sure they didn't outlive their retirement savings. Target date funds are one such option and were the topic of discussion at the *Benefits and Pensions Monitor* Meetings & Event's session, 'Target Date Funds.'

The panelists were:

- Bradley Hicks, Managing Director and Co-head of Canadian Distribution for MFS Investment Management (MFS)
- Pat Leo, Director, Institutional Business, Ontario and western Canada – Sun Life Global Investments
- Jean A. Young, Senior Research Analyst – Vanguard Center for Retirement Research.

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"According to one major insurance carrier, the vast majority of net flows on their recordkeeping platform are going into the default fund options," said Bradley Hicks, Managing Director and Co-head of Canadian Distribution for MFS Investment Management (MFS). As well, "we are now entering an era where the incoming cohort, at least in corporate plan environment, is only going to be exposed to a DC or a group RRSP for their working careers."

TRANSITION TO DC

This transition from defined benefit to DC has always meant shifting a certain amount of responsibility to plan members. And plan sponsors and consultants have done a good job of framing the choice architecture, getting people to default into more prudent, long-term vehicles.

However, he said, the industry spends too much time on subjects such as active versus passive investment management, tactical versus strategic, 'to' versus 'through,' measurement of success, and risk management.

In terms of DC funds, active versus passive is not really relevant as "in our opinion, there is no such thing as a passively-managed target date fund." The perception among plan participants is that passive products are actually lower risk for the investor and that point could be debated. However, "investment gains are going to be a more significant part of an ending balance in long-term DC plans than contributions along the way will ever be," Hicks said. For DC investors, this makes investment gains critical as they build on their early contributions.

Tactical versus strategic management is another debate. This

Bradley Hicks, Managing Director and Co-head of Canadian Distribution for MFS Investment Management (MFS); Pat Leo, Director, Institutional Business, Ontario and western Canada – Sun Life Global Investments; and Jean A. Young, Senior Research Analyst – Vanguard Center for Retirement Research; shared their views on target date funds.

deals with a provider's opportunity to underweight or overweight in the tactical sense. Tactical managers have the ability to take positions in the market based on short-term themes and might be able to avoid downturns or capitalize on opportunities. However, in target date funds, short-term positions can change the risk profile of individual funds and the overall glide path. "The idea of having the flexibility to get out of the way or to capitalize on a certain opportunity in the marketplace sounds great conceptually, but, like any investment decision, one has to really get their heads around skill level. These things are pretty hard to do repeatedly. You don't want to deviate too much from the overall glide path and introduce an unintended outcome."

GLIDE PATH

Plan sponsors should consider the glide path when considering 'to' versus 'through' management. In the U.S. market, slightly more than 80 per cent of plan participants are actually out of their fund within three years of hitting retirement. "If that's really the experience, that most people have moved on and have done something else for post-retirement, why are we spending so much time on debating 'to' versus 'through'?

Another consideration is how success is measured in the target date arena? "Although the efficacy of target date managers can be assessed over shorter periods, target date investments are for the long haul and many providers have not been tested across market inflection points. We need to have a better conversation around time horizons, what a true market cycle looks

like, and how we evaluate different managers through different parts of the cycle. We've got the luxury now of having several providers in the Canadian marketplace that have more than 10 years managing target dates, so providers can go back and study them."

RISK MANAGEMENT

Finally, while there is much discussion of risk management, "ultimately, target dates are long-term investment products and their success is going to be dictated by the philosophy, the design of the portfolio, the glide path and underlying asset allocation, and the process around how the provider views risk management," he said

The industry would do well to spend more time understanding and appreciating the differentiating features and overall TDF design. How a provider has thought about their glide path and the underlying asset classes needs to be understood as these are the things that are going to change the ultimate outcome.

"We need to strive for a more dynamic and more informed analysis and discourse on performance in the investment business generally. Going back and analyzing how different investment products perform, particularly through an inflection point – that's where you get the best information.

"In the end, we should really remember the end investor, the stakeholders – the plan members who are trying to save for retirement."

"Does your default deliver?"

Pat Leo, Director, Institutional Business Development, Ontario and western Canada – Sun Life Global Investments, said, "when we look at a default, it's a long-term pool of investment capital and when you look at a DB plan, the same sort of statement could be made," he said. It also represents retirement savings for the majority of plan members within a plan. Again, this is very similar to DB in the sense that that is usually a larger component of the retirement savings plan for a plan member.

Finally, plan members delegate the investment decision-making to a plan sponsor which is similar to DB.

In terms of the defaults being used now, plan sponsors are using money market funds, standalone balance funds, and target risk and target-date funds. Statistics from Sun Life Group Retirement Services, the largest record-keeper in the industry, show approximately 54 per cent of defaults being used today are target date funds, followed by money market (18 per cent) and target risk funds (14 per cent). And that surprises Leo. "When you think about where we've been over the last several years, to have money parked in a money market fund as a default is somewhat interesting."

The numbers also show four out of five new plans are choosing target date funds as a default option today so there is a clear trend that sponsors are moving to target date funds.

So, are they working for members? The five-year data shows target date funds seem to make sense for members.

This is especially true from a risk perspective. Millennials, aged 20 to 29 who face spending their entire careers in DC plans, are currently investing about 50 to 60 per cent of their money in equities. So early on when they have time on their side to weather any volatility within the marketplace and really accumulate savings, "they're not taking on enough risk, they're not taking on enough equities within their portfolios to get them where they need to be at 65." The same members in target date funds are starting with approximately 90 per cent equity and over their working career end at 30 to 40 per cent. The risk within those portfolios is professionally managed, however, and "that's very important from an investment perspective. We would suggest that from a risk perspective, being invested in a target date fund would make a lot of sense for the average member out there."

And while target date funds are the new default when you look at DC plans, are they truly delivering from an evolution perspective? "In other words, a target date fund five or 10 years ago should be evolving with the industry and keeping pace with the markets," he said

ALTERNATIVE INVESTMENTS

This can be reflected in the asset mix, especially alternative investments. For example, the asset mix of the Canada Pension Plan in 2010 included five per cent in infrastructure and six per cent in real estate as well as private fixed income and commercial mortgages. Fast-forwarding to March 2016, the allocation to infrastructure and real estate has increased by 10 per cent because returns within these asset classes have been significant in recent years.

Many agree that these "alternative asset classes" present a compelling investment opportunity for plan members and that target date funds are the logical vehicle to access them.

A closer look at private fixed income, another alternative, makes a lot of sense, said Leo, as typically the allocation to fixed income increases along the glide path to retirement. This means the fixed income allocation is going to have a huge impact on a fund and, ultimately, on a member's experience.

With continued economic uncertainty, allocating private fixed income to the fixed income sleeve of a target date fund represents a unique and attractive diversifier as it typically provides low correlation to traditional public bonds. It can also offer the potential opportunity to enhance yield due to their illiquid nature.

The trick is "we're not suggesting that this should be a fund that should be offered as a standalone to a member." Instead,

this should be within a managed solution like a target date fund where the liquidity can be managed professionally.

Leo said as more and more plan members come into the workforce faced with DC options or group RRSPs, they are going to be looking to the default. "We're going to have to make sure from an industry perspective and as plan sponsors that the default makes sense for that plan member. We all have a fiduciary responsibility to make sure that the target date fund you're using not only makes sense today, but makes sense going forward."

Jean A. Young, Senior Research Analyst – Vanguard Center for Retirement Research, said people really only need to get two things right to make DC plans work for them. They need to save enough and they need to invest appropriately and "our research shows that it's the savings decision that is more important."

When these plans were first rolled out, it was "all about managing your own money and as an industry and as plan sponsors, we genuinely believed that we could educate all Americans on how to invest appropriately. Thirty years later, we realize how naïve that might be."

The reasons it's so hard to educate plan members are they need to be engaged "and that's extraordinarily difficult." These are mathematics concepts and "people shut down around mathematics."

In terms of what is happening in the target date space in the U.S., she said the Vanguard Center for Retirement Research 'How America Saves' research has had the same headline for the past five years – the rising usage of professionally-managed options. At the end of 2015, 42 per cent of those 3.9 million individuals in its database were solely invested in a single target date fund. Another two per cent held a traditional balanced fund and four per cent had signed up for a managed account program. "So nearly half of participants are not constructing their own portfolios anymore and that's huge." For new plan entrants in 2015, the number is even higher as 78 per cent were solely invested in a professionally-managed option.

The inflection point in the U.S. system was in 2006 when the Pension Protection Act gave auto-enrollment the green light. If sponsors chose a qualified default investment alternative (QDIA), then they were granted fiduciary protection. "In the States, it's huge to get these extra fiduciary protections wherever they can," said Young. The result is at the end of 2015, 69 per cent of all plan participants held some target date fund exposure with 42 per cent only holding their 401(k) plan in a target date fund.

However, there are still mixed investors. "We know that half of mixed investing comes from plan sponsor action. We still have a lot of company stock in the U.S. and there's not an insignificant number of people that are matched or have other employer contributions in company stock. If I as a participant chose a 100 per cent target date fund and then my employer contribution comes in the form of employer stock, I am now a mixed investor," said Young.

However, if 50 per cent of mixed investing arises from plan sponsor action, "that means 50 per cent of mixed investing arises from plan member action. We took a look at what these people that choose to be mixed investors are doing. By and large, they're holding the target date fund at the core and then they hold a couple other funds."

This may be due in part because if there's one concept the industry has managed to educate members on, it is diversification. "They don't want all their eggs in one basket," but they don't understand that a target date fund is a very diversified portfolio.

At the end of the day, Young said there is no reason to worry about mixed investors because no one is a pure investor. Typical participants likely have accounts with previous employers, they own their home, there is a social security asset, a brokerage account from a former employer, or employee stock purchase plans. "You have this huge diversity in what people bring to the table when they get to retirement," she said.

"But, remember, I said people need to get two things right," she said. The real challenge is on the savings rate front because while "we have moved the dial on plan participation through rising adoption of automatic enrollment," the savings rates stayed relatively flat. Even if the employer contributions that are made to these plans are factored in, they've stayed flat over the past decade.

"Given that we had the Great Recession and the global financial crisis, the fact that they stayed flat is good. But what we really need to see is stronger savings rates for most of the population," said Young. BPM

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