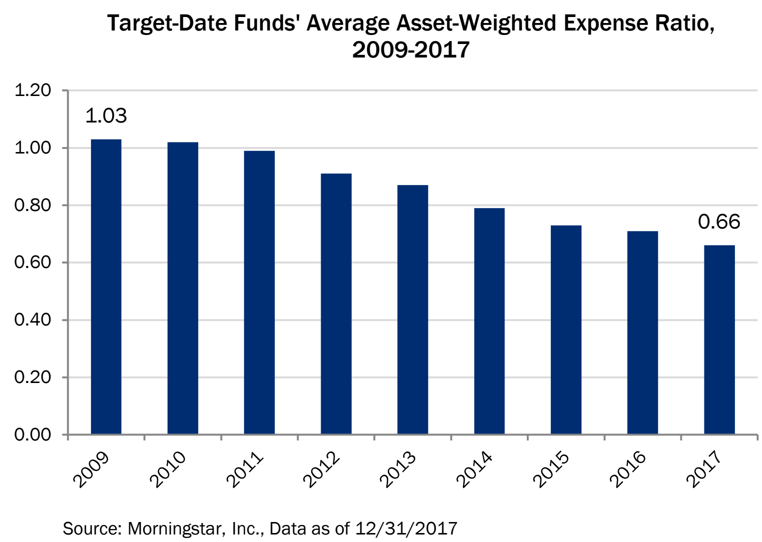
November 2018

Retirement Plan Design:
Target Date Funds

BACKGROUND

Willis Investment Counsel constantly evaluates our processes, methods, and portfolio construction preferences for the $2+ billion that we manage. We strive to ensure that we are always offering our best thinking and execution to clients. One of our primary areas of emphasis in the management of retirement plans is cost. While we have not utilized them in the past, the fees associated with target date funds (TDFs) have continued decreasing to the point where they may be appropriate for *some* retirement plans. This memo is intended to share our research and viewpoint on the use of target date funds in retirement plans.

As the graph illustrates, target date funds (TDFs) have reduced cost over the past several years. While Willis Investment Counsel does not make portfolio construction decisions based on what "most" do, the reduced cost, and increased adoption[1], of TDFs has encouraged us to take a closer look at their design and the efficacy of such investments in portfolios. While target date funds are convenient and offer many beneficial characteristics, they are not perfect solutions, just as any investment option is not the "perfect" solution for all portfolios.



Target date funds are intended to provide investors with a portfolio that utilizes an automatic "sliding scale" to account for risk tolerance. This sliding scale varies based on an assumed retirement date. In other words, those clients that select a 2020 Retirement Fund will have significantly higher exposure to bonds and "cash-like" investments than a 2050 Retirement Fund which has a much longer runway, and thus can tolerance a higher level of equity risk. As with any investment, there are pros and cons to incorporating this approach in a portfolio. Herein we detail that analysis.

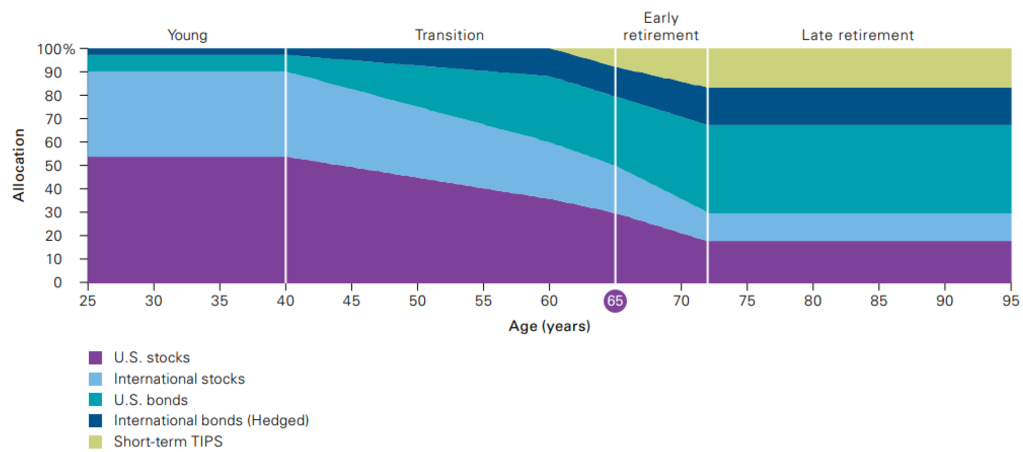
[1] According to Vanguard's *How America Saves 2018*, the percentage of participants using target date funds when they are included as an option in an investment "menu" has nearly doubled since 2008.

Target date funds (TDF) offer many features that are intended to help investors simplify and dynamically diversify their portfolios. The following describes some of the benefits of TDFs:

- They are simple to use.
    - TDFs automatically adjust their allocation based on a sliding scale determined by the TDF company (e.g., Vanguard or T. Rowe Price). In other words, the participant does not have to make a change to their allocation in order to adjust the risk over time.

- They automatically reduce risk as participants age.
    - As the above point alludes, the asset allocation becomes “less risky” as the participant nears retirement. For example, TDFs may start with an allocation of 90% equities/10% bonds at age 25, but by the time the participant is 65, that allocation may be closer to 60% equities/40% bonds.

Example of Vanguard’s Target Date Fund Glide Path



Notes: Figure assumes that a particular fund was selected based on a projected target retirement age of 65. TIPS = Treasury Inflation Protected Securities (see discussion of TIPS later in the text).
Source: Vanguard.

- They are relatively cost-efficient.
    - Most actively managed strategies incur higher fees to the participant. TDFs are monitored and asset allocation is adjusted over time, which is characteristic of actively managed strategies. However, the fees are usually lower than a typical actively managed strategy.

- Perhaps most importantly, *they promote patience and a long-term philosophy*.
    - Because asset allocation is automatically shifted (from high equity exposure to lower equity exposure), participants should not necessarily need to make a change simply to feel as though they are being good stewards of their capital. By investing their funds in a mutual fund that already makes changes according to the participant’s age, they can adopt a “set it and forget it” mentality; which helps the participant practice a patient, long-term mindset and reduce timing risk.

While target date funds have positive attributes, we also address those features that could be viewed as constricting or providing an incomplete financial analysis:

- Bonds are not necessarily a "sure thing" particularly when interest rates and inflation are rising.
  - Moving to a more heavily weighted bond portfolio as retirement nears makes an overly simplified assumption that bonds *will* protect capital. However, declining bond prices can be harmful to participants' overall return when the market is in a rising interest rate environment. Additionally, as inflation rises, retirees will continue to need *more* from their portfolio in order to keep up; regardless of how careful they may be with their spending. This makes a heavier bond component even more challenging to the overall longevity of the portfolio.

- There is no "industry standard" target date allocation sliding scale.
  - Asset allocation changes within a TDF do not adhere to a "hard and fast" rule. While one fund company may believe that 20% equities in retirement make sense, another may determine that 30 or 40% is appropriate.

	Equity Exposure	Fixed Income Exposure
Vanguard Target Retirement 2040 Fund	85.00%	15.00%
T. Rowe Price Retirement 2040 Fund	82.30%	17.70%
Fidelity Freedom 2040 Fund	91.93%	8.07%
JPMorgan SmartRetirement 2040 Fund	83.20%	16.80%

Allocations as of 9/30/2018

- Target date funds do not consider participants' holistic financial picture.
  - Individuals who are taking social security and/or maintain significant cash in the bank already have a bond-like component contributing to their income. Because of this, having a 60-80% bond component in a TDF may make the holistic portfolio too conservative. Additionally, target date funds do not consider other portfolio assets.

- Target date funds allow for less flexibility in asset class diversification.
  - For investors that may want to increase or decrease their portfolio risk in response to drastic changes in the market, target date funds leave them locked into the pre-determined allocation. In the event that the stock market experiences a 20% correction, there is no opportunity to move capital from bonds to equities in order to take advantage of lower stock prices.

CONCLUSION

We acknowledge that there is no one way to design a retirement plan. Willis Investment Counsel believes that simplicity and understandability is the best route in any investment design. As described above, target date funds allow participants to create a simple, diversified portfolio designed to consider risk tolerance as retirement nears. While this is sufficient for many, it is important to recognize that target date funds do not take into account an investor's *entire* financial picture. Additionally, while the TDF industry as a whole has reduced cost, one must pay particularly close attention to the cost of any TDF that may be considered for inclusion in a particular plan; as the cost of TDFs varies among providers. As the graph on the prior page shows, the cost of TDFs varies among providers.

As with any investment decision, individuals must determine what the overall best fit is in regard to additional portfolio assets and their characteristics (income generating, increased volatility, liquidity, etc.), and make a holistic decision based on those elements. Therefore, while TDFs might make sense for some plans, they are not necessarily the best option for all retirement plans.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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