Target-date funds: A solid foundation for retirement investors

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In the wake of recent stock market declines, target-date portfolios—designed for retirement-plan participants who want to simplify their investment decision-making process—have come under scrutiny. This isn't surprising. In 2008 the returns on these funds, like the returns on most portfolios with some stock market exposure, were generally negative.

At Vanguard, we continue to believe in applying a long-term perspective when evaluating any investment strategy and we continue to believe that target-date investing remains a sensible and appropriate investment choice for retirement investors.

In this paper, three Vanguard experts provide their views on target-date funds.

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John Ameriks, Ph.D., director of Vanguard Investment Counseling & Research, examines the investment case for target-date investing.

Steve Utkus, principal
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Steve Utkus, director of Vanguard Center for Retirement Research, analyzes how target-date fund investing can help improve participant investment decisions.

Ann Combs, principal
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Ann Combs, director of Vanguard Strategic Retirement Consulting and former Assistant Secretary of Labor, explains the fiduciary benefits of designating target-date funds as a qualified default investment alternative.

Part one: The investment case for target-date investing

John Ameriks, Ph.D., principal
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At its most fundamental level, the investment case for target-date funds rests on two key principles:

1. In exchange for bearing stock market risk, investors have, on average, earned a significant return above that of fixed income assets or cash equivalents. We have no reason to believe this will change in the future.

2. Younger investors generally have the wherewithal to bear more risk than older investors.

While the economic and market downturn has handed investors poor returns on assets of all types, recent events do not call into question either of these two basic principles. There are, of course, arguments over the design of target-date funds. Yet the basic principles—that market risk is rewarded by a higher expected return, and that older investors can tolerate less risk than younger investors—are fundamental to all target-date strategies and to retirement investing generally.

Risk, reward, and long-term perspective

Given the consensus on these key points, the debate about investing in target-date funds, in our view, is not really about target-date funds. It's about whether retirement savers should bear market risk at all and whether higher returns "on average" are sufficient reward to compensate for the related risks. This is an important debate with a decades-long history, and a point on which people may have strongly differing views.

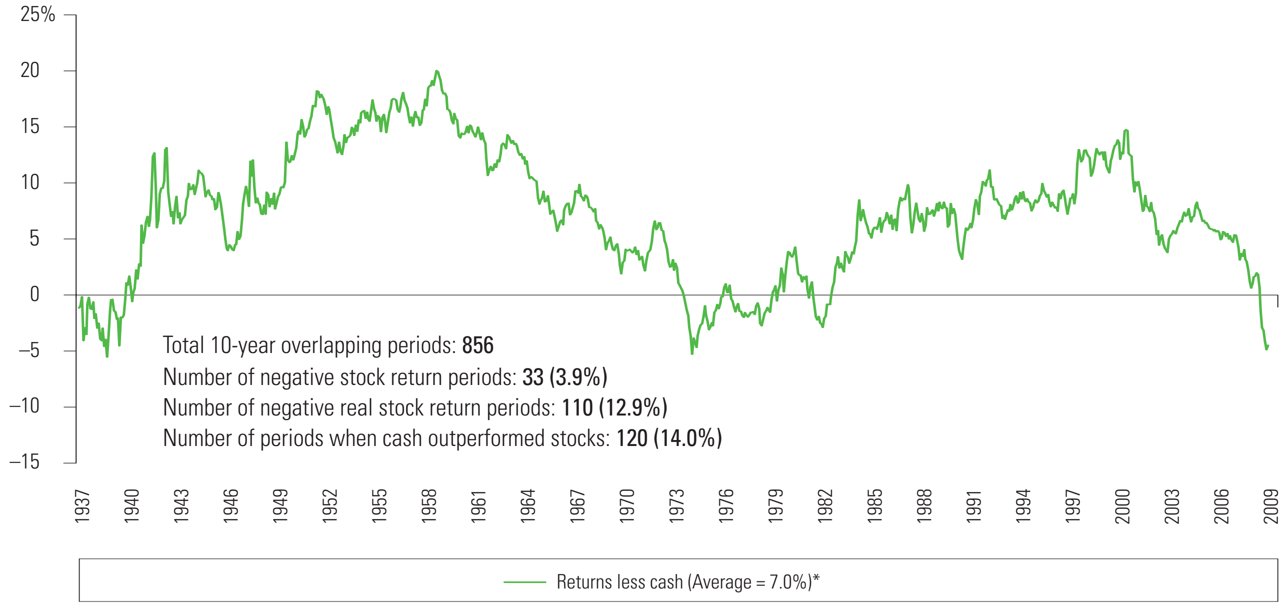
It is our view that there are two important reasons that justify an equity risk premium for retirement investors. The first is the historic record: over most periods in the past, and in many countries, stock market investors have been rewarded with such a premium. The chart below shows historical returns on equities in excess of the 90-day U.S. Treasury bill ("cash") over all 10-year periods from December 1937 to March 2009 **(Figure 1)**.

The second reason is forward-looking: the long-term outlook for global corporate earnings, despite today's enormous short-term challenges, remains positive. The fact that some investors are questioning the outlook for equities is precisely why those who do invest in stocks can expect to earn higher average returns than investors who choose less volatile investments.

We acknowledge that in the months following one of the most dramatic and painful declines in stock market history, it is particularly difficult to maintain a balanced and forward-looking perspective on the potential benefits of equity market investing. Despite the difficulty of doing so, we strive to maintain this perspective, and encourage investors to do the same.

Though everyone wishes there were an investment that promised equity-like returns with guaranteed outcomes, it does not, and will not, ever exist. The only strategy relatively unscathed in the turmoil of 2008 and 2009 is an all-cash or insured portfolio—an investment in Treasury bills, money market instruments, or stable value investments. While these investments have clear benefits in a crisis, there is no evidence that investment managers have the ability to reliably anticipate financial crashes like those of 2008 and 2009. An investor would therefore need an all-cash portfolio—from start to finish—to avoid market risk over their saving horizon.

Figure 1. Average annualized 10-year returns on U.S. equity over cash
Months ending December 1937–March 2009



* This is the arithmetic average of the difference in annualized 10-year returns over all overlapping periods shown in the chart. The difference in compound annualized return between the two series from January 1928–March 2009 is 5.3%.

Source: For stock market returns, we use the Standard & Poor's 500 Index from 1928 to 1970, the Dow Jones Wilshire 5000 Index from 1971 through April 22, 2005, and the MSCI US Broad Market Index thereafter. For the returns on cash investments, we use the Citigroup 3-Month Treasury Bill Index.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Yet the long-term average return of cash in excess of inflation has been low (less than 1%), and cash returns have lagged equity returns by about 5.5% on an annualized basis—amounting to an enormous cost differential in most circumstances. Retirement savers investing only in safe assets must dramatically increase their savings rates in order to compensate for the lower expected returns those investments offer.

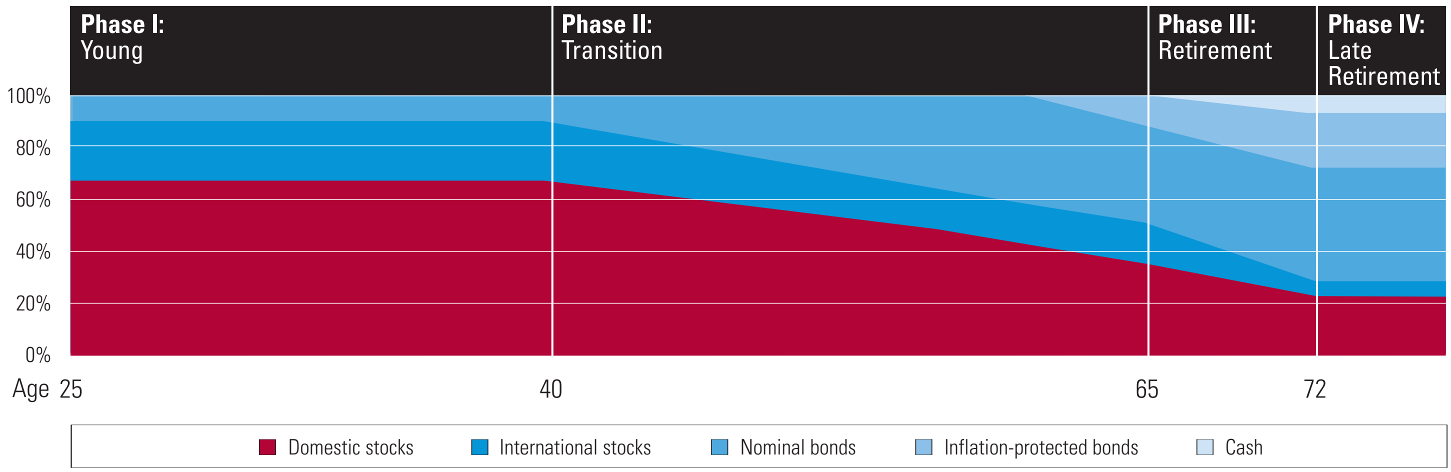
In addition to the steep give-up of expected return, guaranteed strategies such as pensions, annuities, and stable value products, as well as investments such as money market funds, remain exposed to other risks. Many large providers of guaranteed products are currently under severe financial stress. While specific promises to individual policyholders or depositors have not been compromised on a widespread basis in the current crisis, government intervention has been required in some instances to maintain these guarantees, ultimately increasing their price tag.

Transparency, predictability, and low costs

Our two principles—that there are significant potential rewards for taking market risk, and that younger investors are better able to take risk than older investors—underlie our philosophy for constructing Vanguard's target-date funds.

First, investors should, wherever possible, hold a portfolio offering broad exposure to a given asset class—ideally a market index representing that asset holding. Indexing, through its low costs, offers investors the opportunity to capture a very large percentage of the return generated by that asset class. Indexing also eliminates the reduction in performance that can arise from the higher costs and the potential underperformance of active investing. Furthermore, indexing provides transparency—a clear understanding of the investment strategy and holdings.

Figure 2. The Vanguard glide path: A strategic approach



Source: Vanguard.

Recent market volatility has reinforced the benefits of transparency: no suprises, clear valuations, and readily-explained performance.

—John Ameriks

Second, risk-taking should change over the life cycle—not in response to the varying views of a portfolio manager, but to a strategic view of an investor's ability to take risk. The Vanguard Target Retirement portfolio glide path (Figure 2), for that reason, represents a strategic asset allocation to a broadly diversified set of asset classes—not a tactical asset allocation philosophy.

What strategic principle underlies the construction of the Vanguard glide path? It is the recognition that an individual's total net worth consists of both their financial holdings and their future work earnings.

For younger individuals, the majority of their ultimate retirement wealth is in the form of what they will earn and save in the future. Therefore, a large commitment to stocks in their portfolio is appropriate to provide balanced and diversified risk exposure to work-related earnings.

As savers approach and enter their retirement years, more and more of their retirement wealth is in the form of their existing financial wealth. For these investors, the objective is to maintain diversification and balance as they age, gradually decreasing risk in their investment portfolios. But older investors and retirees still need diversification and growth potential to provide income for a significant number of years in retirement, to offset inflation and to meet rising health care and other costs. The very safe, inflation-indexed Social Security benefits are a part of almost all retirees' retirement wealth, and are well-complemented by modest, continued equity exposure.

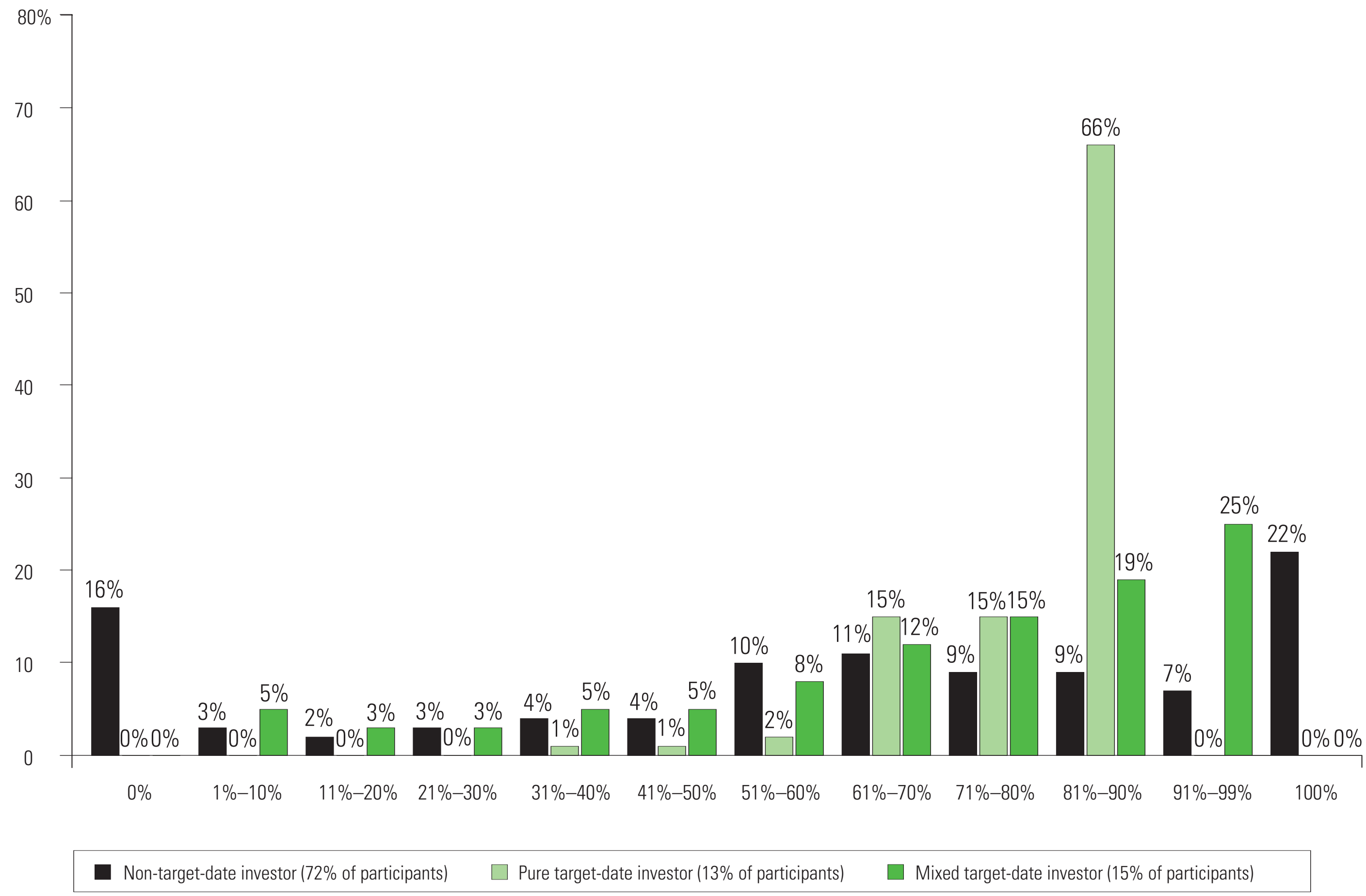
It is also important that target-date fund portfolio construction be straightforward. This simplifies investing for participants and streamlines the evaluation process for plan sponsors. Recent market volatility has reinforced the importance of combining transparency with straightforward portfolio construction: no surprises, clear valuations, and readily-explained performance.

In the end, it is broad-based and low-cost exposure to the capital markets, with risk levels calibrated to the investor's age, that offers the greatest opportunity to grow retirement savings, both in the investor's accumulation and retirement years. It is for these reasons that target-date investing will remain a durable investment strategy in the years to come.

Steve Utkus, principal
Vanguard Center for Retirement Research

Target-date funds are designed to address a particular challenge facing many retirement investors: the difficulty of constructing a professionally diversified portfolio. As academic and Vanguard research indicates, many participants lack motivation or interest when it comes to investment- or retirement-planning matters. Financial education programs can attempt to address these problems, but many participants may still lack the confidence or initiative to take action. Even when motivated, participants may make portfolio errors or fail to manage their portfolio strategy effectively over time.

Figure 3. Distribution of contribution equity allocation among active participants



As of December 31, 2008.
Source: Vanguard.

Target-date funds address these challenges by simplifying the portfolio construction process into a single decision: the choice of an expected year of retirement. All decisions about risk-taking, portfolio construction, and ongoing and life-cycle rebalancing are delegated to the fund's portfolio manager.

How do target-date funds help? According to our research, participants who do not use target-date funds tend to adopt a wide range of varying asset allocations.[1] In fact, four in ten invest at the extremes: for example, 16% of non-target-date investors held zero in equities, while 22% held all of their assets in stocks **(Figure 3)**.

By comparison, target-date investors tend to hold better-balanced portfolios, with equity risk exposures set at levels generally appropriate for retirement saving (e.g., 40% to 90% of portfolios, depending on age). Indeed, by design of the funds, extreme equity allocations were eliminated among target-date investors.

Target-date portfolios also tend to be better diversified in terms of asset classes—for example, diversifying with bonds, as well as international and small-capitalization stocks, which many participants fail to do. Also by design, risk-taking is more closely linked to age.

Behavior in market downturn

During 2008, U.S. and global stock markets were exceptionally volatile and posted sharply negative returns. How did target-date investors react during this extraordinary period? It turns out that, compared with other investors, participants invested in target-date funds were more likely to maintain their portfolio and not over-react to market events.

Target-date investors may come to invest in the funds in one of two ways: either through automatic enrollment or through their own choices (or voluntary enrollment). Both of these groups of participants were less likely to panic—to switch their portfolios to a conservative investment—during 2008, according to our study of the investment behavior of Vanguard-recordkept participants. Specifically, during 2008, 0.7% of

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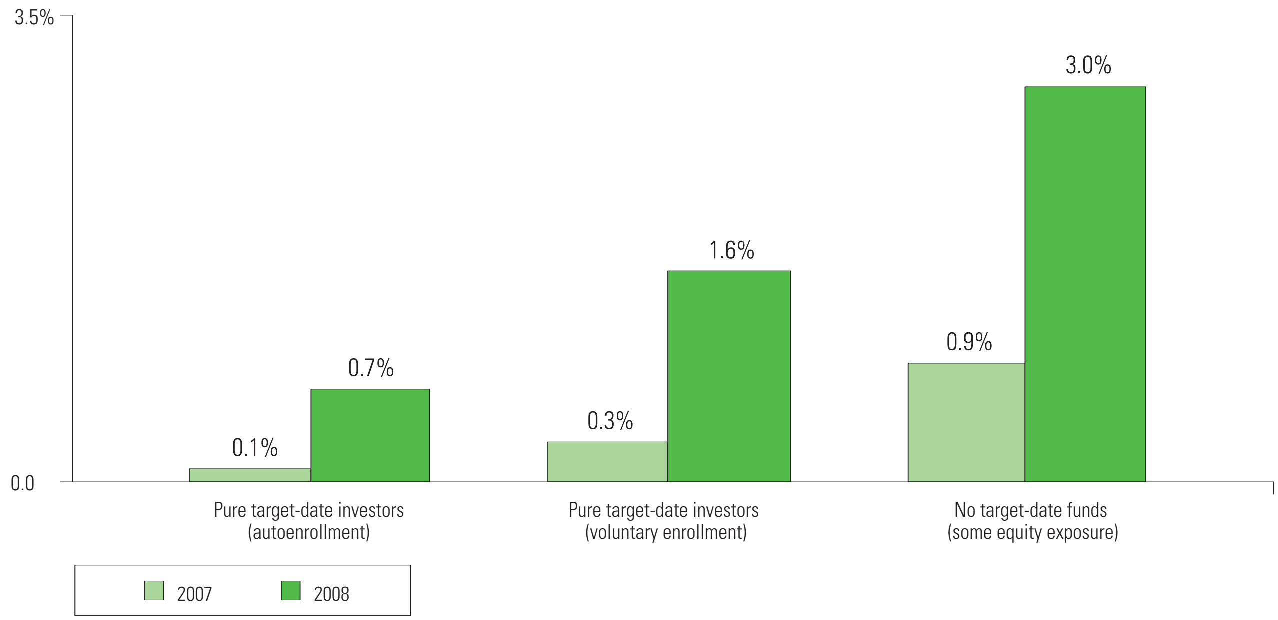
>
> —Steve Utkus

1 *Target-date funds: Plan and participant adoption in 2007*. Vanguard Center for Retirement Research. November, 2008.

participants defaulted into a target-date fund under automatic enrollment shifted their portfolios out of equity during the year, while 1.6% of participants choosing a single target-date fund on their own moved out of the equity markets. By comparison, 3% of non-target-date investors abandoned the equity markets (Figure 4).

Overall, few defined contribution plan participants were fleeing the equity markets in times of historic market volatility. Moreover, participants investing in target-date funds were even less likely to abandon equities.

Figure 4. Annualized equity abandonment rates by investor type



As of December 31, 2008.
Source: Vanguard.

Part three: The fiduciary considerations for plan sponsors

Ann Combs, principal
Vanguard Strategic Retirement Consulting

Participant-directed defined contribution plans, such as 401(k) plans, were developed at a time when individual participants were expected to be active and engaged decision-makers. This was reflected in ERISA itself, which relieved plan sponsors of fiduciary liability for the results of a participant's investment decisions, provided the participant had exercised "control" over the assets. In 1992, the Department of Labor issued regulations under 404(c) of ERISA laying out a series of plan characteristics and disclosures necessary to give participants control. These rules laid out a framework for participant investing that became standard in the industry, but still relied on participants to take affirmative action.

Aided by research on participant behavior, defined contribution plans evolved materially over the past decade. One of the major advancements in plan design has been the introduction and rapid adoption of automatic enrollment. Around the same time, innovative investment products were also introduced, including target-date funds, which are designed to help participants make appropriate portfolio choices.

The rise in automatic enrollment highlighted a gap in the earlier 404(c) regulations, which provided fiduciary protection only if the participant took action. To address this problem and encourage the adoption of automatic enrollment, the 2006 Pension Protection Act (PPA) created a new class of diversified investments known as qualified default investment alternatives (QDIAs). QDIAs would provide plan sponsors with fiduciary protection, even in the absence of participant direction.

The Department of Labor has issued regulations designating three classes of investments as a QDIA: traditional balanced funds, target-date funds, and a managed account option. Each of these options is designed to ensure that participants have an asset allocation that is appropriate for a long-term retirement investor. So far, target-date funds have been the overwhelming choice of Vanguard plan sponsors. As of December 2008, among Vanguard-recordkept plans designating a QDIA, 85% had selected a target-date fund.

There are other requirements that sponsors must meet under the QDIA regulations. These include notifying participants in advance, providing them with the opportunity to make an affirmative investment selection, and allowing them to move into another investment without financial penalty. Sponsors also retain responsibility for prudently selecting and monitoring all investment options, including the QDIA.

Selecting a QDIA is critical for plan sponsors using automatic enrollment. With more and more of their participants in a default investment, sponsors will want to ensure that they receive fiduciary relief by directing those participants' contributions into a QDIA.

A QDIA may also be used in other settings—for example, for participants who join the plan but fail to provide an investment election, or for participants who fail to make an investment election for a non-elective contribution. In any of these cases, the use of QDIA as the default investment means enhanced fiduciary protection for the sponsor.

Target-date funds and reenrollment

The QDIA regulations also spawned a new plan strategy—reenrolling participants and defaulting their investment holdings and new contributions into a QDIA. Reenrollment is an emerging strategy for plan sponsors changing recordkeepers, consolidating plans in a merger or acquisition, undertaking a major change in their investment menu, or introducing a new designated default fund (such as replacing a stable value or money market default with a target-date fund). It can also be useful when the sponsor's goal is to improve the overall quality of diversification of participant portfolios.

Although the decision to reenroll participants is a business decision, implementing the strategy is a fiduciary act. Therefore, before implementing reenrollment, a plan committee should go through a well-documented, deliberative process during which a number of important issues should be considered and the rationale for the decision documented. There are a variety of considerations to weigh. They are addressed in a related Vanguard report.[2]

Target retirement portfolios: A better starting point for participants

It is our view that target-date investing is one of the most significant and promising innovations in the retirement savings marketplace in recent years. Target-date funds can make it easier for all participants—even those who may be complacent investors—to assemble a well-diversified portfolio. Innovative plan-design strategies—such as reenrollment—make it sensible for plan sponsors to adopt target-date funds to help guide participants toward their investing goals. And, new QDIA regulations offer fiduciary protection when such funds are used as the default.

Target-date portfolios at Vanguard are constructed based on a number of investment best practices designed to help long-term investors achieve their goals—the principles of asset allocation, diversification, transparency, and the balance among risk, return, and cost.

As is the case with all our funds, Vanguard Target Retirement portfolios have characteristics that can make them a good starting point on the road to investment success—expert portfolio construction, prudent management, and low costs. In short, our Target Retirement portfolios offer the very best in diversified investing for sponsors and participants who want a low-cost, simplified approach to investing.

Target-date funds have been designated by the Department of Labor as a QDIA that can provide sponsors with fiduciary relief. Of the three types of QDIAs, target-date funds have been the overwhelming choice of Vanguard plan sponsors.

—Ann Combs

2 *Improving plan diversification through reenrollment in a QDIA.* Vanguard Strategic Retirement Consulting, September 2008.

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Although Target Retirement portfolios can simplify investment selection, all funds are subject to risk. Target Retirement portfolios are subject to the risks associated with their underlying funds. Diversification does not ensure a profit or protect against a loss in a declining market.

Investments in bond funds are subject to interest rate, credit, and inflation risk. While U.S. Treasury or government agency securities provide substantial protection against credit risk, they do not protect investors against price changes due to changing interest rates.

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