



A Rough Road Toward 2010: A Performance Comparison of Active vs. Passive Target Date Funds

Craig L. Israelsen, Ph.D.*
November 25, 2008

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Way back in 1994, the first target date funds were introduced. Back then, a target date of say, 2010, seemed so far away. But, here we are now just 14 months from 2010—the first major target date.

A large cohort of investors are scheduled to hit the shores of retirement in 2010. Basically, it's the folks that were born in the mid 1940's. You'll recall that the baby boom is defined as the 18-year period from 1946 to 1964. So, a lot of the money invested in 2010 funds belongs to the leading edge baby boomers.

As of late 2008 there was about \$26 billion invested in 2010 target date funds. As a point of reference, a total of \$192 billion was invested in all target date funds as of late 2008 (that is the asset total in retail target date funds and doesn't account for the assets in collective trust target date products). Target date funds linked to the year 2020 have the single largest asset base, at around \$42 billion.

The distribution of assets among the 32 2010 funds in existence as of 10/31/2008 are hardly proportional. As shown below, the 6 largest 2010 funds possess about 92% of all 2010 assets.

Six Largest 2010 Target Date Funds (as of 10/31/08)	Total Net Assets (\$ Million)	Percentage of All 2010 Target Date Fund Assets (Largest 6 funds have 92% of all 2010 assets)
Fidelity Freedom 2010	10,574	50%
T. Rowe Price Retirement 2010	4,416	21%
Vanguard Target Retirement 2010	2,252	11%
Principal L/T 2010	1,381	6%
American Funds Target Date Rtmt 2010	450	2%
Wells Fargo DJ 2010	411	2%

Data Source: Morningstar and Target Date Analytics (www.TDBench.com)



So, with the year 2010 bearing down on us, how have 2010 funds fared in this ugly equity environment? Is the descending “glidepath” of a target date fund protecting investors as they approach their retirement date? Moreover, has active management (the dominant approach among target date funds) added value vis-à-vis the passive alternative of the PLANSPONSOR On Target 2010 Index? The PLANSPONSOR On Target Index (or OTI) is a series of target date indexes (Current, 2010, 2020, 2030, 2040, 2050) that primarily utilize passive indexes within a conservative asset allocation model. The On Target Indexes are distinct in two important ways. First, they are broadly diversified across 8 asset classes. Second, the glidepath of the OTI emphasizes risk control near the target date.

As 2010 funds are so close to hitting their target date, many might assume that they have hunkered down primarily in bonds and cash and have largely sidestepped the equity market slide that began in June 2007. As shown below the six largest 2010 target date funds have each experienced serious losses in 2008. The two funds that follow a more passive, index-based strategy (Vanguard 2010 and Wells Fargo 2010) have fared better, but are still deeply in the red.

In 2007, the 2010 funds that use actively managed funds within the portfolio (recall that virtually all target date funds employ a “fund-of-funds” approach) generally lagged the performance of the target date funds employing passively managed components. Interestingly, they all fell short of the performance standard set by the PLANSPONSOR On Target 2010 Index in 2007.



Six Largest 2010 Target Date Funds (as of 10/31/08)	Portfolio Components (Active or Passive)	Total % Equity Allocation in Portfolio	Total % Return in 2007	Year-to-Date % Return as of 10/31/2008	3-Year Annualized Return as of 10/31/2008
Fidelity Freedom 2010	Actively Managed Funds	49.4	7.4	-23.7	-2.4
T. Rowe Price Retirement 2010	Actively Managed Funds	59.1	6.7	-25.5	-2.4
Vanguard Target Retirement 2010	Passive Index Funds	54.4	7.7	-21.4	--
Principal L/T 2010	Actively Managed Funds	60.0	3.6	-28.3	-5.0
American Funds Target Date Rtmt 2010	Actively Managed Funds	61.9	--	-26.7	--
Wells Fargo DJ 2010	Individual Stocks, Index-Based Allocations	32.4	7.1	-15.2	0.1
PLANSPONSOR On Target 2010 Index	7 Passively Managed Index Funds, 1 Actively Managed Fund	8.1	9.0	-7.4	3.2

Data Source: Morningstar and Target Date Analytics (www.TDBench.com)



The PLANSPONSOR On Target 2010 Index (developed and maintained by Target Date Analytics) has far less exposure to equities and therefore has suffered far less in 2008. Its 2008 YTD return as of October 31 of -7.4% is half the loss of the Wells Fargo 2010 fund, roughly one-third the loss of the Vanguard, Fidelity, and T. Rowe Price 2010 funds, and about $\frac{1}{4}$ of the loss sustained by the Principal and American Funds 2010 funds. Over the 3-year period ended 10/31/08 the performance of the PLANSPONSOR On Target Index was significantly higher.

In short, compared to the passively managed index-based PLANSPONSOR On Target 2010 Index, the performance of 2010 target funds that utilize actively managed funds has gone from bad in 2007 to way worse in 2008. Active target funds lagged the OTI performance by approximately 200 bps in 2007. So far in 2008, the two largest target date funds (both of which use actively managed ingredients) lag the OTI by about 1,700 bps. 2008 has been a real stress test of the entire industry and active target date funds are failing—particularly those that have past or are near their target date.

Recall that target date funds are qualified default investment alternatives (QDIA) within the provisions of the 2006 Pension Protection Act. A “default” investment vehicle should take a more conservative approach. It is my opinion that an aggressive investment vehicle should be chosen by the participant, not defaulted into. Recall that the default investment assets were cash and stable value until recently.

Of the thirty two 2010 target date funds in existence right now, nearly all of them are too aggressive as they approach the target date—regardless of whether they are using actively managed funds or passively managed indexes inside the portfolio. Their glidepath-based asset allocation models—typically 50% to 60% equity—are simply too aggressive as they close in on the target date. The PLANSPONSOR On Target Index stands alone in its more conservative allocation model as it approaches the target date. Not surprisingly, its performance year-to-date, as well as 3-year, 5-year, and 10-year returns, far surpasses all other 2010 funds.

Swinging for the fences with a 63-year old investor’s money is not the purpose of a 2010 target date fund. At that point, the primary goal should be asset protection so that the investor can arrive safely at the target date and then make needed plans for the retirement income distribution phase.

So, why are nearly all target date funds designed so aggressively? Two primary reasons: 1) Competition. Best performance sells best. 2) Misinterpretation of what the stated target date represents. If the stated target date merely represents a speed bump in the fund’s glidepath toward the “real” target date



(which must apparently represent the death date of the investor) it is clear why so many 2010 funds are so equity heavy near the stated “initial” target date. The fund design (i.e., the asset allocation model) has a built in assumption that any losses in the final years leading up to the initial target date can be recovered in the subsequent 15-20 years. This is an extremely bold assumption that nearly forces the investor to stay in the target date fund if heavy losses were sustained in the 1-2 years prior to the stated target date. This is certainly one way to retain assets post-target date, but I strenuously oppose it.

In summary, a target date fund that fails to attenuate risk near the target date has failed in its primary purpose. With that as the premise, nearly all 2010 target date funds are failing. Even worse, virtually all the target date funds coming down the pike (2015 funds, 2020 funds, etc.) are cut from the same cloth and will experience large losses near the target date if the equity market declines near the target date. Of course, the problem is largely fixable. The most obvious fix is to retool the target fund glidepath to take less equity risk as the target date approaches. The “fix” is available now—it’s called the PLANSPONSOR On Target Index series. For further information see www.TDBench.com.

Craig L. Israelsen, Ph.D. is a professor at BYU. He is a principal at Target Date Analytics (www.TDBench.com) and the designer of the 7Twelve Portfolio (www.7TwelvePortfolio.com).

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>