

Target-Date Perspectives

# A Framework for Comparing and Choosing a Target-Date Provider

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This report outlines some of the key differences among target-date funds, in order to help plan sponsors evaluate target-date providers.

## Introduction

In recent years, target-date funds have significantly changed the investment landscape of defined contribution retirement plans. These life-cycle, single-solution retirement investments have:

- Accrued over \$300 billion in assets
- Been included in 96% of DC plans that offer automatic enrollment
- Exceeded the “total returns [including cash flow] of other types of mutual funds over the past three years” \*

The primary reason for this success is their unique design, which allows target-date funds to systematically reduce equity exposures over a plan participant’s working life. This helps simplify the asset allocation decision for participants, while helping plan sponsors meet fiduciary and QDIA requirements.

Behind that simplicity, however, lie multiple allocation approaches among target-date providers, a lack of standardized practices and a wide dispersion in returns. Plan sponsors increasingly need to become familiar with the major differences among target-date funds in order to match the needs of a plan with the choices available.

This overview of the target-date landscape can help plan sponsors identify:

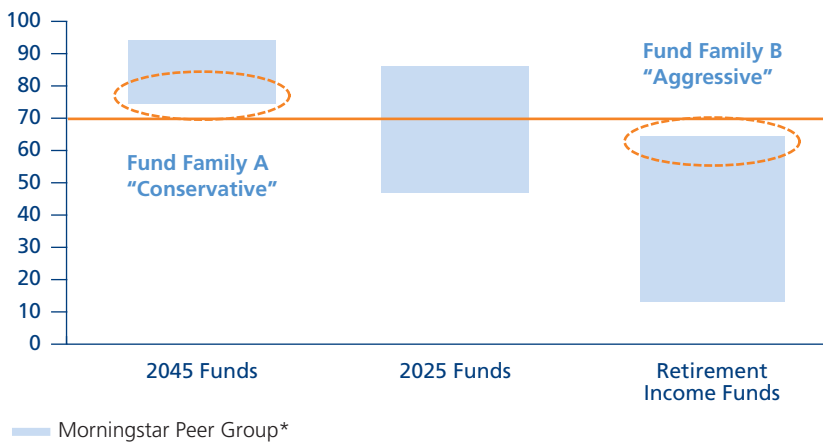
- Factors that make it challenging to compare target-date funds
- The three key target-date variables
- Strategies for using target-date options to better fulfil plan sponsor fiduciary duties

\* Source: Morningstar, “Target-Date Series Research Paper: 2010 Industry Survey,” 11/09.

## A Moving Target: The Challenge of Comparing Target-Date Funds

Traditional tools that have proven useful in evaluating single asset class products, such as peer group rankings, have been largely ineffective when comparing funds like target dates that use multiple asset classes and have changing risk profiles. The primary reason for this, as shown in Figure 1, is the wide variance in equity allocations among different providers at all target-date stages.

**Figure 1. Equity Allocations Vary Wildly Among Lifecycle Funds**



The blue bars represent the range of equity allocations for all peers within each Morningstar category. Morningstar is an independent service that ranks mutual funds and variable annuities. We deem this information to be correct but cannot attest to its accuracy.

This wide range of allocations results in different benchmarks and differing perspectives on how participant allocations should evolve as their capacity for risk decreases. In a universe that is still very small and diverse—fewer than 40 target-date families and less than a third of managers with a five-year track record—this can result in volatile peer group rankings (as seen in Figure 2).

**Figure 2. The Best Managers in 2008 Were Among the Worst Performers in 2009**

Quartile Rankings as of 12/31/08	Quartile Rankings of Same Funds 1 Year Later (Represents Morningstar's 2021-2025 Target Date peer group)			
	Top Quartile	Second Quartile	Third Quartile	Bottom Quartile
Top Quartile	0%	8%	16%	76%
Second Quartile	5%	45%	30%	20%
Third Quartile	17%	66%	7%	10%
Bottom Quartile	83%	0%	13%	4%

Source: Morningstar

- Seventy-six percent of funds in the top quartile of their peer group in 2008 were in the bottom quartile in 2009.
- Eighty-three percent of funds that ranked in the bottom quartile of their peer group in 2008 were in the top quartile in 2009.

It's possible, depending on the provider, for an investor in retirement to have almost the same equity allocation as one who does not plan to retire until 2045.

It is broadly accepted that no single firm can excel at managing every asset class. Yet the majority of target-date managers use only proprietary funds.

## The Three Key Target-Date Variables

Behind the divergence in returns and volatility there are three important design choices that determine how a target-date fund meets its goals. Evaluating each of these considerations can help plan sponsors decide whether a given target-date provider aligns with a plan's investment objectives.

### 1. Type of Manager: Open Investment Architecture versus Closed

Many plan sponsors look to a multi-manager platform to fulfill their fiduciary duty regarding plan choices. There are many potential advantages of this approach:

- An open-architecture approach enables plan sponsors to access the best managers across various asset classes.
- The allocation options can play off the strengths, philosophies and capabilities of different managers.
- Having multiple management companies diversifies away from overexposure to one asset manager.
- As target date products evolve, new asset classes, such as emerging market bonds, may be added to underlying fund lineups. Firms only using in-house managers are unlikely to have products available in all asset classes, especially in the more specialized areas.

Giving a plan investment options with sufficient diversity can be critical. The challenge here is that few target-date providers allow investments outside of their complexes. In fact, only five out of the 20 largest target-date managers allocate meaningfully to non-proprietary active managers. And few providers employ separate underlying funds to allocate to non-traditional asset classes.

### Target-Date Funds as Qualified Default Investment Alternatives

Making sure retirement plan investments are prudently managed and properly diversified is part of the fiduciary duty of plan sponsors, because they act on behalf of retirement plan participants (and their beneficiaries). However, ERISA plans relieve fiduciaries from liability for investment outcomes if individual plans allow participants to exercise control over their investments.

In cases where participants fail to make elections, a Qualified Default Investment Alternative (QDIA) also alleviates the fiduciary's investment responsibility, as long as the QDIA is prudently selected and monitored. Target-date funds have become attractive candidates for QDIA's because they tend to be both diversified and sensitive to the changing risk profiles at different stages of careers. To perform the necessary due diligence, however, plan sponsors may wish to thoroughly evaluate the varying management styles and objectives among target-date strategies.

Source: U.S. Department of Labor

## 2. Type of Retirement Approach: Managing “To” versus “Through” Retirement

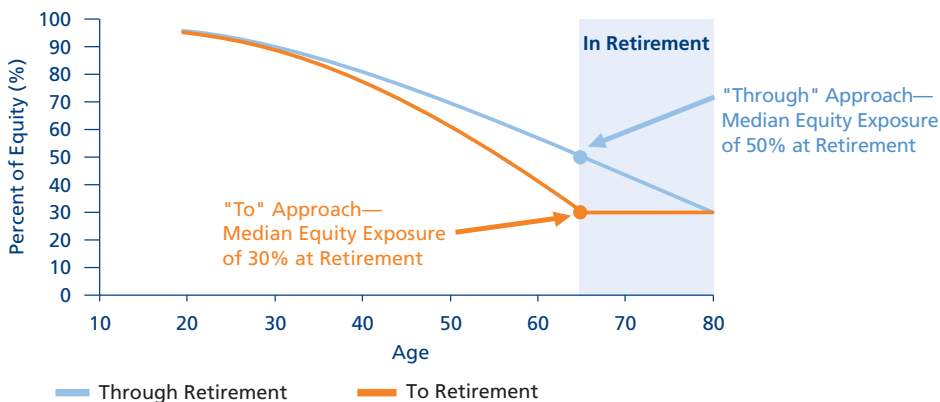
The 2008 financial crisis saw many retiring participants withdraw from target-date funds, only to find their equity exposures much higher than one would expect at the decumulation phase. The cause of this was differing—and unstated—expectations between manager and investor; the manager expected the investor to continue investing long past retirement, while many investors expected to begin distributions upon reaching retirement. How a target-date manager approaches the retirement date—which involves the distinction between managing “To” versus “Through” retirement—is one that plan sponsors should examine, to determine whether the provider is managing to plan participants’ needs and expectations.

“To” retirement approaches generally reach their most conservative allocation at the retirement date—anticipating that the investor wants to begin withdrawing funds at retirement age.

The “Through” approach uses a glide path that maximizes equity exposures—and thus accumulation potential—by maintaining a more aggressive posture at retirement age. It is not uncommon for “Through” funds to reach their most conservative allocation sometimes 15-30 years after the retirement date.

The decision to select a “To” vs. a “Through” manager is critical because target-date managers’ equity allocations diverge the most during the years immediately before and after the retirement date.

**Figure 3: High Equity Allocations at Retirement May Create Unnecessary Risk**



Source: ING Investment Management

Please note: The above chart is for illustrative purposes only. Actual equity allocations can vary significantly between target date managers before and after the retirement date.

“Several consultants said plan sponsors would be best served to examine a target-date fund’s glide path and objectives, rather than focus solely on performance.”

U.S. Government  
Accountability Office Report  
January 2011

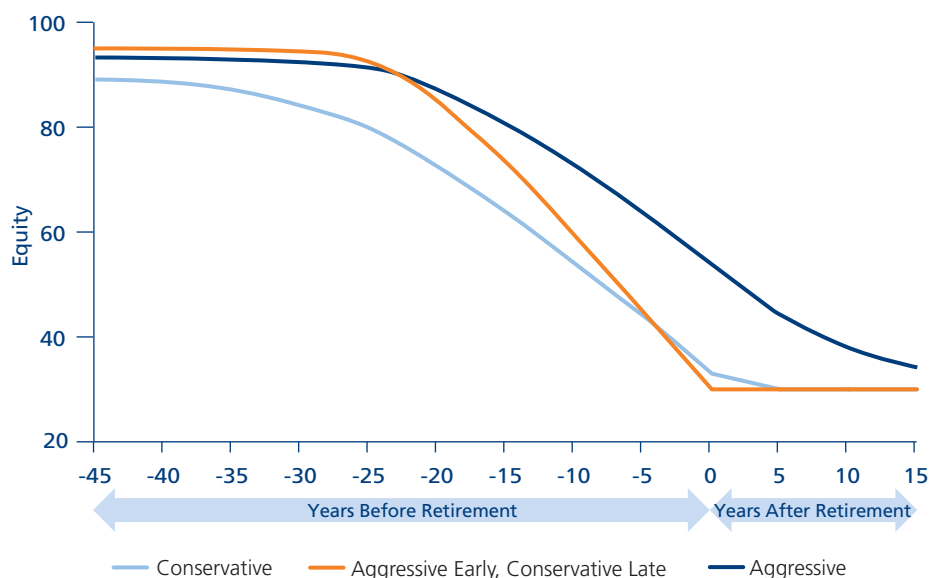
### 3. Type of Glide Path Transition

A target-date fund’s glide path, the way the manager systematically reduces the asset allocation mix over the lifecycle of the fund, can have a significant impact on long-term performance. Glide path transition methodology varies widely partly due to the approach to equity allocations at retirement, but there are other important factors that should be considered when it comes to the optimal design of a glide path transition.

Many target-date managers employ a glide path transition that maintains a consistent risk profile relative to peers throughout the fund lifecycle, while others employ a methodology that changes its risk profile over time to account for the changing appetite for risk throughout a participant’s career. This approach to glide path design addresses the fact that younger participants with goals focused on wealth accumulation can tolerate increased equity exposure early in their careers when there is significant time to recover from potential losses. It also decreases equity exposure more rapidly as retirement nears to mitigate risk when participants are more concerned about wealth preservation and have less time to recover from potential losses. It is important to consider whether the amount of equity exposure throughout the life of a target-date glide path is appropriately suited for the participant base.

Figure 4 is a hypothetical example that compares the varying equity allocations of three different target-date glide path methodologies. It includes an example of an aggressive glide path, conservative glide path and a hybrid approach that maintains an aggressive allocation early in the lifecycle and transitions to a conservative risk profile as retirement approaches.

**Figure 4: Hypothetical Glide Path Transitions**



This hypothetical example is for illustrative purposes only.

The breadth of asset allocation options can also play an important role in effectively managing a target-date glide path transition and should be thoughtfully considered. Some managers only use traditional asset classes like stocks, bonds and international investments while others incorporate alternative investments such as real estate or commodities into the asset allocation mix. This enhanced diversification can potentially help increase long-term performance and decrease volatility within the portfolio. The plan sponsor's goals and comfort level with alternative investments should be considered when deciding the degree to which these strategies should be employed.

## Aiming at the Right Target-Date Solution for Your Plan

ING Investment Management, a leader in target-date investing, offers a range of target-date solutions to meet the diverse needs and risk tolerances of individual participants. We construct the ING target-date solutions with the fiduciary requirements of plan sponsors in mind.

Our target-date philosophy:

- A multi-manager investment approach enhances diversification potential since no single asset manager can excel at managing every asset class.
- Managing target-date portfolios "To" retirement helps minimize the potential for significant loss as retirement nears.
- A target-date glide path should maintain greater equity allocations in early career stages and minimize exposure as retirement nears—thus maximizing long-term potential and minimizing shortfall risk.

Plan sponsors have a responsibility to ensure that the investment products they provide participants are well-aligned with the typical participant's goals, risk tolerance and timeline. Given all the variables involved—including open architecture vs. closed, "To" vs. "Through" and glide path transition—evaluating target-date funds can seem like trying to hit a moving target. By understanding the differences among target-date offerings and how they impact participant outcomes, sponsors can feel confident that they are choosing the best target-date solution for their plan.

Contact your **ING Representative** for more details on how target-date funds can broaden plan options while potentially simplifying plan sponsor duties.

At ING, we believe the best approach to target-date design combines best-in-class managers across a broad range of asset classes with an intelligent glide-path design.

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There is no guarantee that any investment option will achieve its stated objective. Principal value fluctuates and there is no guarantee of value at any time, including the target date. The "target date" is the approximate date when an investor plans to start withdrawing their money. When their target date is reached, they may have more or less than the original amount invested. For each target-date portfolio, until the day prior to its target date, the portfolio will seek to provide total returns consistent with an asset allocation targeted for an investor who is retiring in approximately each portfolio's designated target year. On the target date, the portfolio will seek to provide a combination of total return and stability of principal.

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