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Target Date Glide Trap: Retiree Risks on the Rise

A White Paper by Manning & Napier

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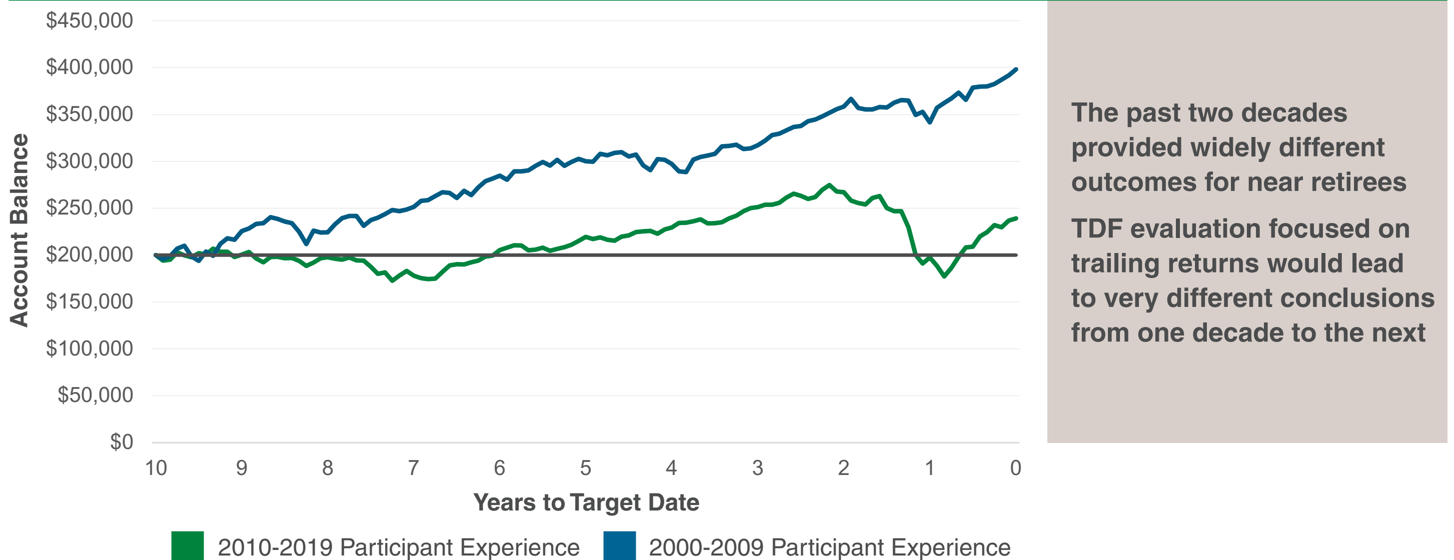
Unless otherwise noted, all figures are based in USD.

Investors over the past 20 years have experienced a wide range of markets starting with the 'lost decade' from 2000 to 2009 followed by one of the longest bull markets in history from 2010 to 2019. These diverging decades likely led to vastly different retirement outcomes for participants. For example, based on the median target date fund (TDF) returns intended for those within ten years of retirement at that time, participants either barely broke even over the course of the 2000s or more than doubled their retirement nest egg over the most recent decade. While most would agree the next decade will be different than the last, the unprecedented and accelerated market movements in 2020 were a reminder that target date solutions have important differences and trade-offs that must be considered in light of unknowable future market conditions. In this paper we will explore some of the recent trends, lessons learned and future considerations in target date due diligence.

What a Difference a Decade Can Make



Source: Morningstar, Inc. Analysis by Manning & Napier. Unless otherwise noted, data as of 12/31/2019.
The TDF Universe includes all mutual funds categorized as target date funds by Morningstar. The analysis is based on the quarterly return of the median mutual fund within the Morningstar Target Date 2020 Category during 01/01/2000-12/31/2009 and the median return within the Morningstar Target Date 2030 Category during 01/01/2010-12/31/2019 to reflect the experience of a near retiree during both decades. Analysis doesn't include contributions or distributions.

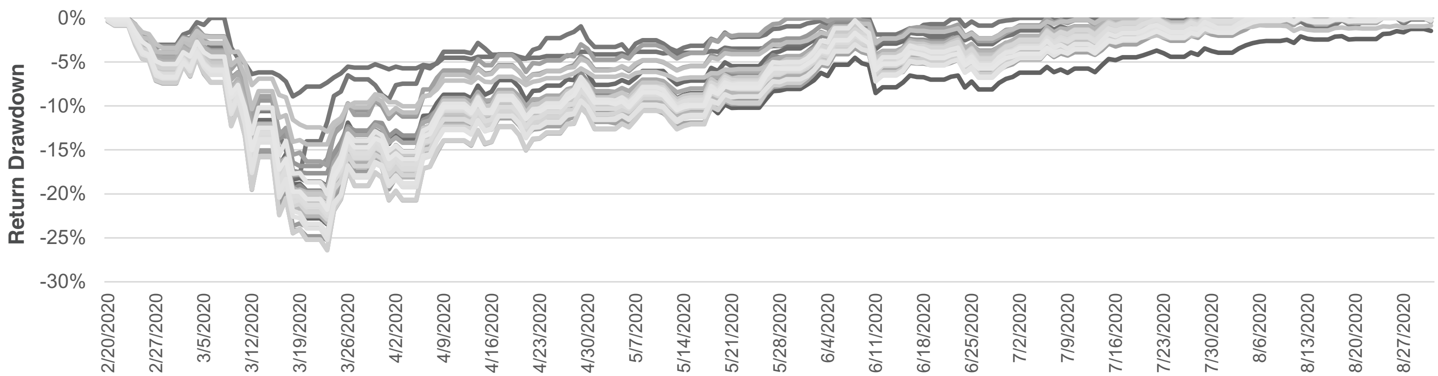
The past two decades coincide with the emergence and growth of target date investment solutions. TDFs were available in the early 2000's but their use and breadth of offerings exploded with the creation of Qualified Default Investment Alternatives (QDIAs) as part of the Pension Protection Act of 2006. They quickly became the favored QDIA choice for their ease of use and ability to help address well established participant behavioral challenges.

Just as TDFs started to gain traction in the QDIA role, the Global Financial Crisis hit and erased significant wealth for a wide range of investors, including participants using TDFs. Even those invested in 2010 funds – vintages that should be conservative given how close they were to their target year – saw losses as severe as -49%. The range of losses among TDFs during this period, highlight the fact that there were material differences in investment philosophies and objectives. As importantly, it also brought to light the need to ensure a plan's TDF solution provides a good fit for participants through both good and bad times. In fact, during 2013, the Department of Labor issued guidance in selecting and monitoring TDFs, urging plan fiduciaries to fully examine the principal strategies and risks of a prospective provider's approach to TDF investing.

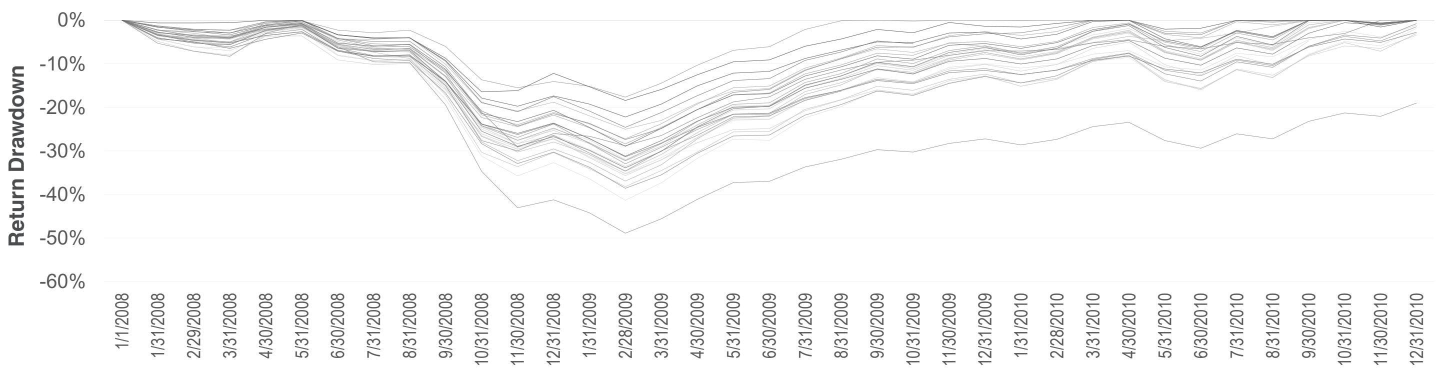
The decade since the Global Financial Crisis has been more favorable for participants, characterized by strong returns and low volatility for equities, which has propelled average 401(k) balances to record levels. There are important implications of this market environment for plan fiduciaries as well. Since due diligence programs are commonly based on standard trailing time periods, such as three- and five-year intervals, recent performance snapshots were bull market biased. In fact, as of the end of 2019, the trailing 10-year time period reflected a generally one-directional market environment.

While providing adequate growth is a critical aspect of helping participants reach their long-term objectives, it is important not to lose sight of the impact capital losses can have during market downturns. This became abundantly clear during the first quarter of 2020 as the market experienced losses of a magnitude not seen since the Global Financial Crisis over a decade ago.

Target Date Turmoil Today



Target Date Turmoil a Decade Ago



Source: Morningstar. Analysis by Manning & Napier. The analysis includes all mutual funds within the Morningstar Target Date 2010 Category in the 2008-2010 analysis period and all mutual funds within the Morningstar Target Date 2025 Category in the 2020 analysis period.

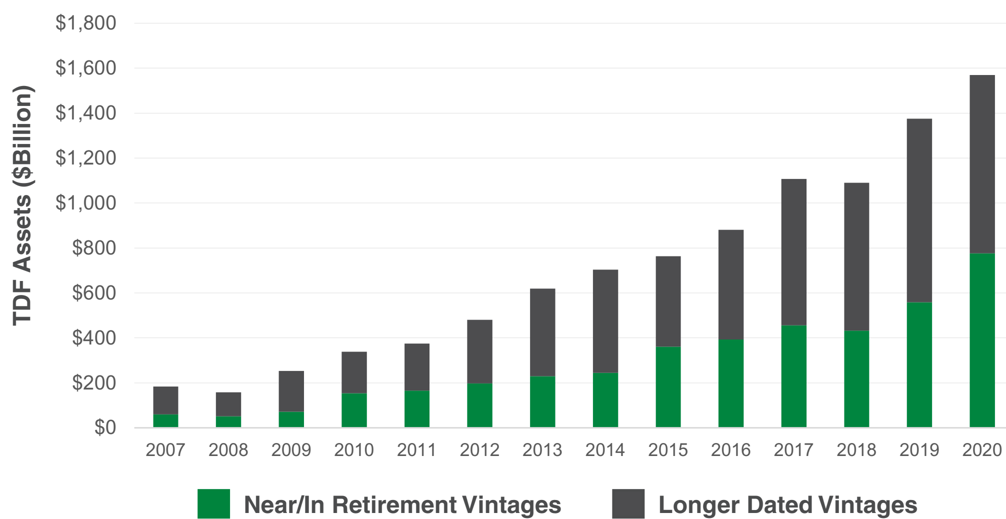
Drawdowns are disadvantageous from a mathematical perspective as a greater gain is needed to offset a loss, but they are also impactful from a behavioral standpoint. Behavioral finance insights over the past few decades have made it clear that participants who are invested more aggressively than their risk tolerances dictate are more likely to engage in damaging yet avoidable behavior, such as selling their investments at unfavorable prices during market downturns and buying back in only after the market has rebounded and appreciated significantly. As a result, participants may have a more difficult time staying the course and ultimately achieving their retirement goals.

The temptation to do the wrong thing at the wrong time only increases for many participants as they near retirement. This type of response during stressful market events is understandable. Losses become increasingly larger in dollar terms as balances grow, and the reality of having fewer years to make up any lost ground begins to set in. In fact, a survey found that 77% of investors support managers protecting their portfolios from losses, even if it results in periods of underperformance. This percentage grew to over 83% for those older respondents (over 60) who are closer to retirement[1].

[1]Source: Ignites, September 2017

Participants' views on the risk/reward balancing act are important for plan fiduciaries to keep in mind as they select and monitor their plans' TDFs. Assets intended for participants nearing or in retirement have swelled. Specifically, TDF assets in vintages near or in retirement have grown significantly since the Global Financial Crisis, exceeding $770 billion at the end of 2020. With these assets experiencing an increase of over 1000% since 2007, the next sustained market downturn may have a much larger impact on this group of participants that can least afford to suffer significant losses. It's worth noting that this asset figure doesn't include plan assets managed in Collective Investment Trust (CIT) vehicles. It's been well documented that target date CITs have experienced tremendous growth over the past decade and currently account for over 40% of all target date assets[1].

Strong returns and QDIA status have propelled TDF assets higher, particularly in near retirement vintages



TDF assets in vintages near and in retirement have grown significantly since the Global Financial Crisis

The next market downturn may have a much larger impact on more investors with greater balances at risk

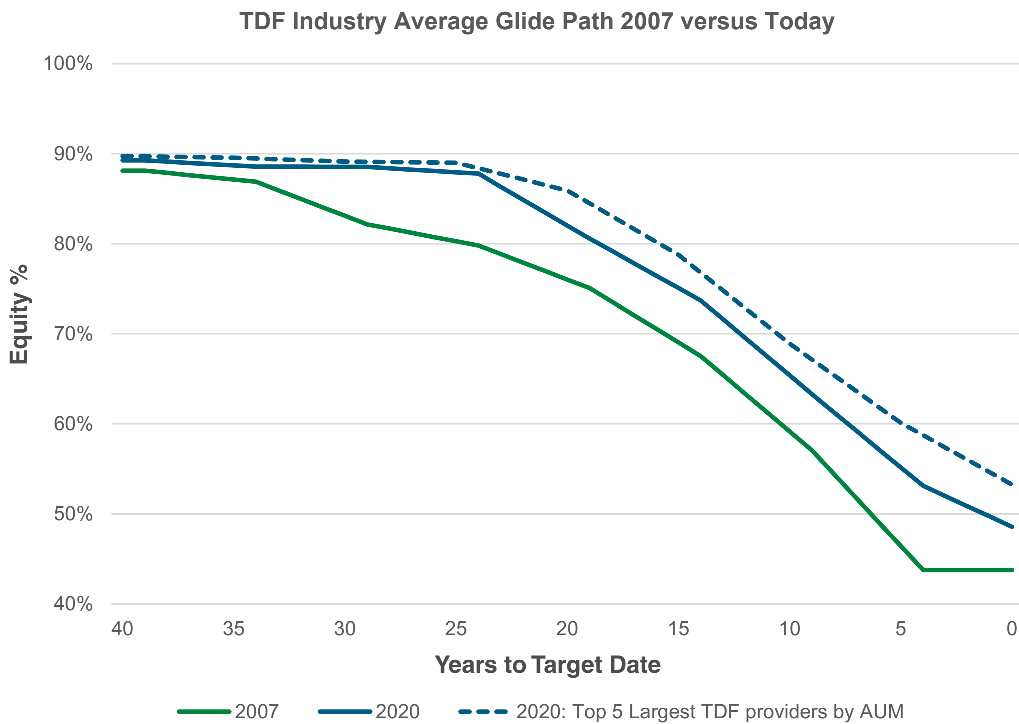
	Year-End 2007	Year-End 2020
Overall TDF Assets	$184b	$1.5t
TDF Assets Near/In Retirement Vintages*	$60b	$777b
% of Assets in Near/In Retirement Vintages*	33%	49%

Source: Morningstar, Inc. Analysis by Manning & Napier. Unless otherwise noted, data as of 12/31/2020. The TDF Universe includes all mutual funds categorized as target date funds by Morningstar.
*Defined as vintages within 10 years of their identified target date.

It's important to realize that the equity exposure of the average glide path in the industry has increased significantly since the Global Financial Crisis as seen in the illustration on the following page. Of the growing TDF asset base, our analysis further indicates that over three-quarters is invested in five TDF families. While there are likely many reasons that these TDF providers have been successful in growing and/or retaining their market share, a notable commonality among them is that, on average, they are governed by even higher equity glide paths. Due in part to their glide path positioning, these TDFs have, on average, outperformed more conservative counterparts during this extended bull market run.

[1]Source: Morningstar Target Landscape Report, March 2021.

TDF Universe: Glide Path Equity Comparison



Over three-quarters of TDF assets are invested in Five TDF families

On average, these five TDF families are governed by higher equity glide paths that have provided strong returns this decade

Group Average	TDF Universe Market Share	Average 10-Yr Annualized Return	1Q 2020 Intra-Quarter Drawdown*
Five Largest Fund Families by Assets	79%	9.09%	-22.7%
All Other Fund Families	21%	8.08%	-18.3%

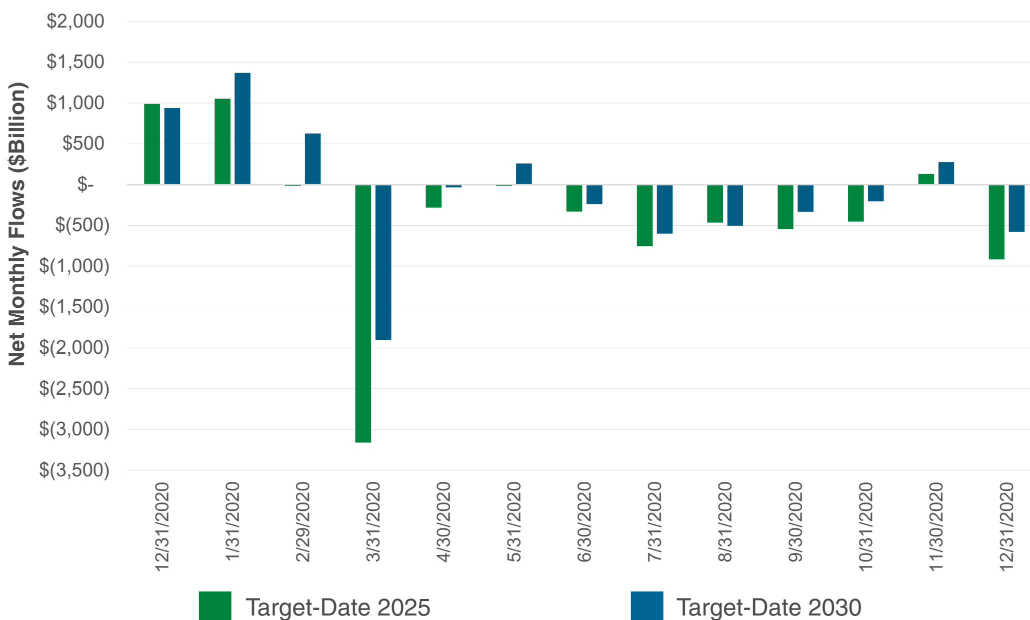
Source: Morningstar, Inc. Analysis by Manning & Napier. Unless otherwise noted, data as of 12/31/2020. The TDF Universe includes all mutual funds categorized as target date funds by Morningstar.
*Includes 2025 target date vintages only and return period is defined as 02/20/2020-03/23/2020.

That stated, during an equity market downturn, TDFs governed by higher equity glide paths may have difficulty meeting the needs of risk averse participants, as well as those that are relying on retirement assets to support daily living expenses. Given the significant increase of assets in near retirement vintages, the stakes are much higher for TDF providers to help participants successfully navigate the next inevitable sustained downturn. Consider that during the brief but significant Q1 2020 Intra-Quarter Drawdown, the five 2020 funds with the highest allocations to equities lost, on average, more than 20% more than the remaining funds within their peer group.

Behavioral Warning Signs for Near Retirees

While the extreme market sell-off in early 2020 was short lived (broad equity markets ended the year higher than where they started), the potential warning signs of risk aversion can be seen in the target date mutual fund flows. While the longer-dated vintages resumed net inflows, near retirement vintages broadly experienced net outflows even though the equity markets rebounded strongly in 2020.

Target Date Mutual Fund Flows in Near Retirement Vintages



Despite the strong equity market rebound, near retirement vintages remained primarily in net outflow mode over the remainder of 2020

Source: Morningstar, Inc. Analysis by Manning & Napier. Unless otherwise noted, data as of 12/31/2020. The TDF Universe includes all mutual funds categorized as target date funds by Morningstar.

Conclusion

Much of the last decade has provided a generally favorable market backdrop for participants to build and spend down their retirement wealth. However, the extreme market volatility in 2020 has brought more challenging times back into focus. The heightened risks and concerns due to the Global Pandemic's impact on retirement savers as well as the massive amount of assets held in TDFs have once again caught the eye of legislators, with Congressional leaders calling on the Government Accountability Office to conduct a review of the target date landscape in the near future.

Given these concerns and changing environment, plan fiduciaries should be diligent to weigh participant behavioral realities, look beyond bull biased trailing time periods, and incorporate additional metrics such as maximum drawdown and downside capture ratios to evaluate a TDF manager's ability to protect retirement assets during periods of volatility. By adopting a well-balanced due diligence program that considers a manager's ability to both grow and protect assets, plan fiduciaries can further document that the chosen TDF solution is structured to meet the needs of their participant base through a variety of market conditions.

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