INVESTMENT FOCUS

Recognizing long-term progress in target date funds

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There is an unfortunate contrast between the purpose of target date funds and the typical process of evaluating whether a target date fund in the series is doing well. A target date fund provider generally has a very clear rationale for the way the funds are structured, yet the industry generally measures each fund's success relative to peers or a composite benchmark, neither of which is really an outcome. While the funds are intended to provide a career-long investment strategy that will steadily grow to provide retirement income, the common yardsticks applied to track progress typically focus on much shorter time horizons. Certainly, performance over one-, three- and five-year horizons is an effective way to ensure that nothing has gone off the rails, but it may not be the most effective assessment regarding whether a fund is on track to achieve its long-term purpose.

There is an alternative to the typical habit of focusing on short-term time horizons and relative performance metrics—one that better aligns past performance with the overall objectives to which a fund is being managed. We illustrate the proposed method using Russell Investments' target date funds and recommend it as a helpful supplement to short-term performance reporting.

Russell Investments' glide path and target date fund allocations are organized around a "typical" participant[1] and we directly incorporated the characteristics of this representative worker (e.g., salary and contribution rates over time) to identify the investment strategy and to project the range of future account balances that this is anticipated to experience. With the passage of time, we are able to compare the actual progress of the model participant toward the retirement goal to the plan. This comparison serves as a direct assessment of the primary goal of the target date funds.

Using thousands of scenarios supplied by the Russell Investments' forecasting team to represent possible market outcomes,[2] the range of likely future account balances for the typical participant were evaluated in the process of setting the glide path. In Exhibit 1, we illustrate the range of outcomes anticipated in 2014 (the time at which the characteristics of the typical participant were last established) and overlay that projection with the actual performance of a typical participant over time starting at three different ages. We have included the actual fund performance since inception in 2007, which, conveniently, allows us to observe that the painful impact of the Great Recession was, for the glidepath, mostly a temporary setback in the march toward the goal of retirement. To avoid an overly cluttered exhibit, we have included only three of the funds in our target date series: the 2040 fund, the 2030 fund and the 2020 fund. These funds correspond to participant ages in 2007 of 32, 42 and 52, respectively.The solid light blue and gray outer lines in Exhibit 1 respectively represent the 10th and 90th percentiles of the account balance's likely outcomes (based on Russell Investments' forecast assumptions) if the typical participant were to invest in the Russell Investments' glide path. These lines paint a range that is projected to capture the account balance 80% of the time. The collections of lighter lines between the 10th and 90th percentiles are percentiles at 5% increments (15th, 20th, 25th, etc.) with the solid blue line in the middle denoting the median (50th percentile). These lines suggest that at 40 years old, the typical participant's retirement balance is expected to fall between $103k and $246k with a median value of $156k. By the retirement age of 65, the typical participant would accumulate anywhere between $0.5 and $1.5 million.

The horizontal dashed line at $700k (and the bull's eye on the right) represents the target accumulation amount, which is the amount needed to provide the targeted retirement income level for the typical participant described above.

In order to track the progress of our typical participant at different ages, we assume that participants held median (based on the analysis that supported the choice of allocation at the beginning of 2015) account balances at the beginning of 2007 that correspond to $55k for a participant who is in the 2040 fund, $190k for the 2030 fund and $411k for the 2020 fund. The investors share the same characteristics as the typical investor at corresponding ages, including saving patterns, salary growth level, retirement age and target replacement rate.

The orange lines in Exhibit 1 track the account balances of the typical participant starting at ages 32, 42 and 52 as the markets ebb and flow from 2007 through 2017 assuming that they start with the projected median balance in 2007. For investors who started out at the median balance, the Great Recession had a significant impact on the accumulated wealth, pushing it down to the 10th percentile and lower on the range of possible outcomes. In 2009, the account balances for typical participants are down to $321k, $130k and $40k for 2020, 2030 and 2040 funds, respectively. However, Russell Investments' target date funds did well in the next five years and brought

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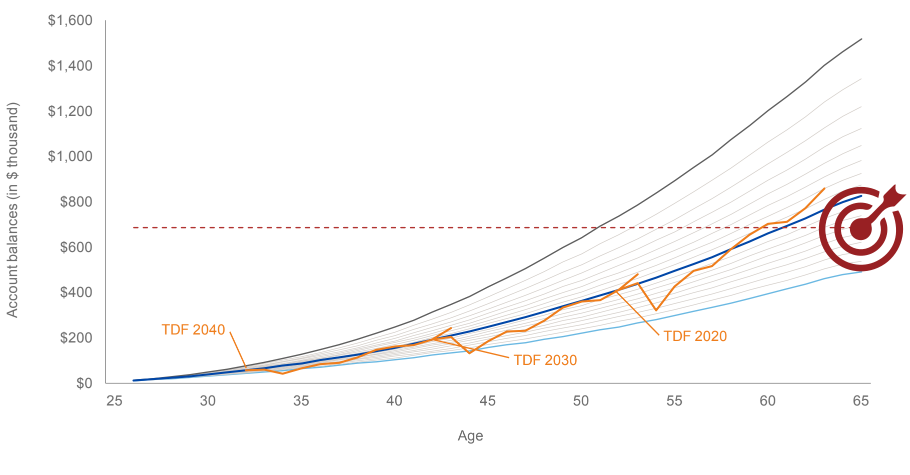
Exhibit 1: Projected account balances for a typical participant compared using actual target date fund performance since inception in 2007.



Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that any stated results will occur.

the account balance above the median anticipated level. In fact, in 2015 at age 60, five years before intended retirement age, investors of the 2020 fund who held the projected median balance in 2007 already exceed the target of $700k. By the beginning of 2018, the balance for typical participants grew to between the 60th and 70th percentiles (the accumulated balances grew to $859k, $478k and $240k, respectively).

Target date funds are designed for long-term investment, and Exhibit 1 shows that participants in the Russell Investments' target date funds are on the path to a successful accumulation in time for retirement. For those who are lucky enough to avoid a significant market downturn and are committed to the specified saving pattern, they might be far ahead of schedule given the favorable market environment.

Of course, this method for tracking the progress of target date funds doesn't simply apply to the Russell Investments' offering. It can be customizable for any plan that has a well specified projection of the range of outcomes that are anticipated for participants. Within a plan, it can be applied to cohorts or individuals with different saving patterns or different retirement income aspirations. Understanding where participants are relative to the plan as they progress to retirement supports decisions to adjust the saving pattern, to delay their retirement or even in more favorable market scenarios to retire earlier than originally planned. This method of tracking the target date funds' progress is also beneficial to plan sponsors in assessing their participants' retirement readiness and allows them to respond by tailoring their communication with the participants in the most effective way.

We believe it is beneficial to supplement performance reporting that focuses on short-term metrics by stepping back to assess progress toward the long-term goals of the target date fund. The longer-term focus provides perspective for participants and plan fiduciaries during turbulent markets and helps them to keep their eyes on the prize.

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REFERENCES

Fan, Y., Gardner, D., Greves, J., and Murray, S. (2014). "Review of Russell Investments' target date fund methodology." Russell Investments Research.

[1] A complete discussion of our typical participant can be found in Fan, et. al. (2014), but a thumbnail description will serve the purposes of this article. We assume a worker whose career starts at age 25 and ends at age 65 with salary growing at an inflation-adjusted 1.3% and final salary of $90,000. Contributions (both employer and employee) start at 9% of salary at the beginning of the career and end at 14% by the time of retirement. We assume that participants seek to replace 79% of their final salary and that Social Security will provide 30% of that amount. We calculate that a final balance of approximately $700,000 is necessary to replace the remaining 49% of final salary and to maintain the participant's pre-retirement lifestyle.

[2] For consistency, we use the same set of forecasts from December 2013 as were used when developing the current Russell Investments' glide path.

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