

Monitoring the success of target date funds

Sean Henaghan | AMP Capital Investors | 24 March 2014

Target date funds (TDFs) are an innovative investment solution which seek to provide a life-long managed investment strategy for superannuation investors. As well as working to the objective of building a lump sum of funds for retirement, they also aim to reduce the risk of experiencing poor investment performance immediately prior to retirement, typically when the portfolio balance is the greatest. The following paper provides an overview of the benefits of investing in TDFs, as well as guidance on some of the complexity around performance monitoring and benchmarking.

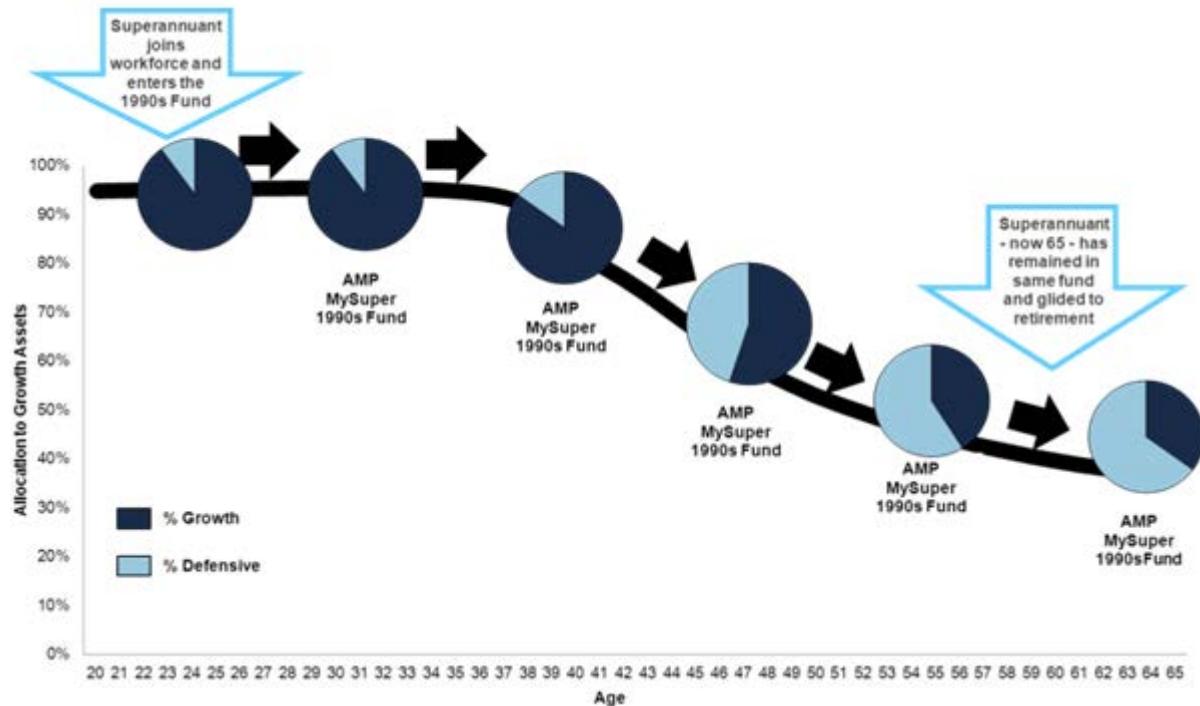
PORTFOLIO DE-RISKS OVER TIME

TDFs work by investing the superannuation member according to the decade of their birth. Members stay in the same fund over their full working life, and the fund's investment strategy de-risks over the member's working life.

During the member's younger years, the investment strategy seeks higher return targets through greater exposure to growth assets such as shares. As the member approaches retirement, the investment aim is to reduce risk and preserve capital, so the asset allocation mix shifts to more stable defensive assets such as bonds. This means that TDFs are able to focus on return maximisation and capital appreciation during earlier stages of the fund's life, while focusing on volatility management and capital preservation as retirement nears.

The rate at which a particular fund de-risks its asset allocation is referred to as its glide path. The trajectory of the glide path and the way in which it is managed will differ materially between fund providers.

Figure 1: A glide path reflects the rate at which the fund de-risks



Source: AMP Capital, December 2013. Shows the glide path for AMP's TDF offering which is based on 10-year cohorts with a non-linear glide path. The glide path's shape ensures that upwards of 90% of all de-risking takes place before investors reach the age of 60.

BENEFITS OF INVESTING IN TARGET DATE FUNDS

1. A targeted solution for disengaged members

A large proportion of default superannuation members are not willing or equipped to make investment decisions about their superannuation. In the management of TDFs, the investment manager automatically takes care of the asset allocation changes on behalf of the member. This means that employers can offer their employees a targeted retirement solution regardless of an employee's level of engagement.

2. A smoother de-risking transition to retirement

TDFs offer substantial benefits over the one-size-fits-all diversified default option which is the current industry convention. Among the benefits of this approach is a smoother de-risking transition to retirement. This can be compared to the sudden age-based step down from growth allocations to more conservative allocations as occurs within a life cycle fund. While TDFs provide an innovative solution for default members, it's important to note that they may not be suitable for all investors. This is because specific individuals may require

risk and return profiles that differ significantly from the profile provided by the glide path.

GLOBAL APPEAL OF TARGET DATE FUNDS

TDFs are growing in prominence globally for superannuation. In the US and UK markets, TDFs are well established with the first funds having been launched in the 1990s and with large inflows beginning in the early 2000s. In the US, in 2007, inflows were further enhanced due to the US Department of Labor's Qualified Default Investment Alternatives regulations. In the UK, the Department of Work and Pensions guidance in 2011 included TDFs as a default option, which also supported popularity of the investment solution.

KEY INGREDIENTS TO SUCCESS

TDFs can vary greatly in terms of their objectives, risk and return profile, asset allocation, member cohort size, investment management style, and the shape of their glide path. Of the myriad of differentiating factors among TDFs, two characteristics are critical to their success: the need for broad diversification among asset classes; and, the need for a goal-based investment approach.

Owning a portfolio with at least some exposure to a variety of key asset classes ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas of the market. This is the fundamental principle of diversification and a critical risk management step.

Superannuation investors, by and large, share the common goal of needing adequate savings to fund a comfortable retirement. With defined benefit schemes growing less common and being superseded by defined contribution schemes, the final retirement outcome from the perspective of trustees and members has become much more ambiguous.

From an investor's perspective, achieving the goal of having an adequate amount of savings to fund retirement is significantly more important than outperforming a benchmark or peer group. It is of little consolation to investors facing an underfunded retirement that the benchmark or a competitor's fund would have placed them in the same predicament.

Focusing on the retirement goal of investors aligns both the investor's and fund manager's interests, and reduces some investment uncertainty for members. In this way, TDFs can be seen as a hybrid between defined contribution and defined benefit funds.

MEASURING PERFORMANCE OF TARGET DATE FUNDS

Monitoring the performance of TDFs is challenging because, unlike traditional managed funds, TDFs have the explicit objective of achieving an adequate level of savings for

investors by the time they reach retirement. They also have a diversified asset allocation mix which changes dynamically from year to year.

This provides complexity around issues of performance monitoring and benchmarking. The following section looks at the areas that investors, trustees and investment governance committees need to assess in monitoring performance of TDFs. That is:

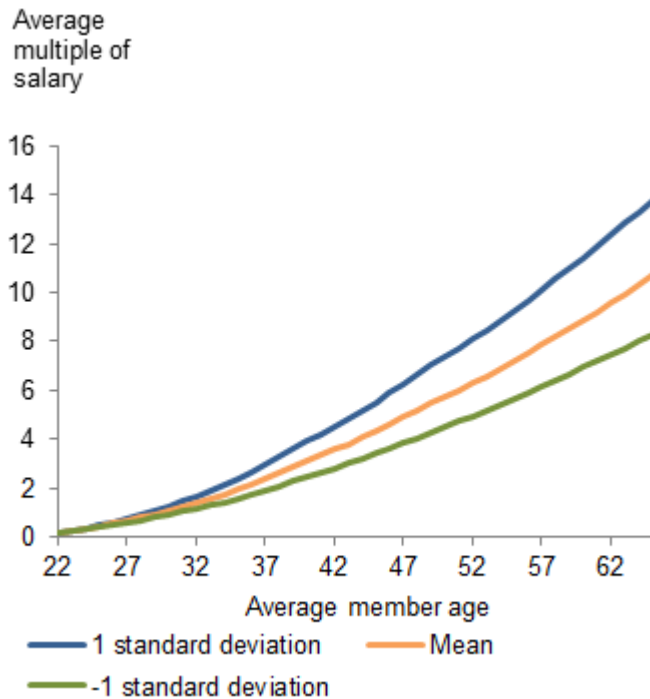
- How is the fund tracking against the investor's goal?
- Are investment managers delivering positive active returns?
- Are the administration, processes and people supporting the fund sustainable?

1. How is the fund tracking against the investor's goal?

1.1. Forecasting the final balance

Measuring how a TDF is tracking against its goal of ensuring adequate superannuation savings requires a forecast of the final balance of members out to the point of retirement (age 65). Assuming that the growth in member salaries and contributions remains steady at the long-term national average, expected investment volatility can be used to compute a range of likely superannuation balances out to retirement. Using a single standard deviation bracket, trustees can monitor how their investment is tracking relative to their final multiple-of-salary retirement goal.

Figure 2: Forecasting the final balance

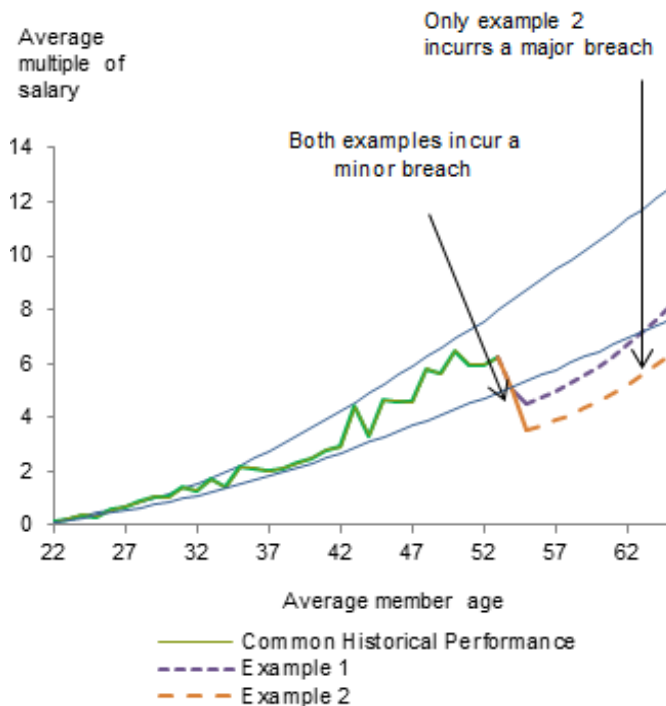


Source: AMP Capital, December 2013.

Over time, as salary growth, contribution rates and investment returns are realised, the fund should be measured against two criteria: whether the current balance of members is within the projected range (one standard deviation); and, whether the projected final retirement balance of members is within the final projected range.

Figure 3 illustrates the two types of breach. Example 1 represents a minor breach where the balance dips below the lower bracket. However, the projected balance remains within the final range at retirement. Example 2 represents a larger fall in the balance with both minor and major breaches occurring.

Figure 3: Two types of Target Date Fund breach



Source: AMP Capital, December 2013.

It's important to note that final multiples of salary are never guaranteed, and market returns will vary significantly through time meaning that outcomes will always be uncertain. However, it's safe to say that, at inception of the fund, the final estimated outcome will be very stable, regardless of market movements or contribution habits. This is because there are large superannuation contributions that will happen in the future that have not yet occurred and therefore current balances are relatively low compared to future inflows. This means funds with young members will almost never record a major breach. However, near-inception funds are much more likely to record minor breaches because the brackets are much narrower in the early stages of the TDF's life.

Conversely, funds with members approaching retirement are more likely to record a major breach because they do not have such long forecast periods ahead of them. The increased size of the balance and the reduced number of remaining working years to recoup losses increases their sensitivity to falls in financial markets. Though marginally offset by the relative wider brackets, this reflects sound investment logic. Young investors who experience an interruption in their contributions or suffer investment losses have time on their side, and are more easily able to make up lost ground. Hence, they should record the major breach less frequently.

As the TDF matures and the current balance increases compared to future superannuation

contributions, the effect on final outcomes will be affected more by market returns and active performance. The monitoring of both minor and major breaches is important. Deviations from current estimates and final outcomes in terms of multiples of salary can act as a flag for discussions with the trustee and members and any appropriate action can be discussed.

1.2. The benefits of a goal-based monitoring system

The intent of TDFs is to provide the member with a benefit that is linked to a multiple of salary at retirement and, therefore, provide a quantifiable income through retirement. While this multiple is not guaranteed, the portfolio will be managed specifically against maximising the probability of achieving that target. Hence, success should be defined by achieving the target and not whether the fund has performed better than other funds.

The benefits of adopting a goal-based monitoring system are many and varied. Aside from aligning the interests of the fund manager with the goals of the investor, goal-based monitoring provides superannuation trustees with a measure to gauge whether or not members are on track to reach adequate savings levels by retirement. This can help with making informed decisions about whether to review the fund's asset allocation mix or have members undershoot the targeted retirement balances. Goal-based monitoring also provides individuals with a way to see how they are tracking towards their goals. This information can then be used to help members decide about what age to retire, whether to make voluntary contributions or if they should change investment vehicles.

2. Are investment managers delivering positive active returns?

Many methods exist for monitoring the active performance of investment managers against passive benchmarks. These include standard single asset class benchmarks such as the S&P/ASX 200 index, CPI plus targets and peer group benchmarks.

2.1. The danger of measuring against peer groups

TDFs can be substantially different to one another due to material differences in their design and overall objectives. Ibbotson enforces these considerations in its 2011 paper *Selecting a Target Date Benchmark*:

"As practitioners and investors stuck in our old ways of thinking, there is an unfortunate tendency to view funds with the same target date year, for example all 2030 funds, as a homogeneous peer group or category, even though the investment characteristics of all 2030 funds are substantially less homogeneous than that of traditional peer groups or categories."¹

In a wider context, Australia's MySuper market will be delineated into TDFs (retail and consultant funds) and traditional balanced funds (industry and corporate funds). This delineation makes peer groups redundant given that TDFs have dynamic strategic asset allocation. This means that while the current asset allocation may, for example, be equivalent to a balanced fund, the historical performance is likely to be equivalent to a growth fund given how these funds de-risk over time. Hence, comparing historical performance between TDFs and other MySuper funds provides no useful information.

Peer groups can also create destructive behaviour between funds where they become more focused on outperforming their peers at the expense of delivering to the stated performance goal of their members. It was noted in the *Journal of Performance Management*, in reference to the US market:

"So far, the competition for target date business has been based on performance and has led most to favour a very gentle application of the brakes, leaving the target date fund in a substantial risky asset allocation at target date. This is dangerous."²

2.2. Custom benchmarks offer a comprehensive solution

Custom benchmarks offer a comprehensive solution to the problem of measuring active performance for diversified TDFs. They provide a tailored solution that can accurately measure both the different sources of active return and different objective through time that are inherent to TDFs.

These benchmarks are combined in the same proportion as the neutral asset allocation from the glide path. Custom benchmarks are dynamic, allowing accurate measurement of the value added by active management (stock selection and tactical asset allocation) relative to the neutral asset allocation.

3. Are the administration, processes and people supporting the fund sustainable?

Qualitative monitoring of key people and processes is an integral component to TDF monitoring. Trustees, consultants, governance committees and investors need to be confident in the processes surrounding risk and performance analytics, decision making, mandate compliance and trading etc. These factors will often dictate the success and failure of TDFs in the future. Assessment of these qualitative factors needs explicit inclusion in a transparent monitoring framework.

THE BALANCED SCORECARD APPROACH

A balanced scorecard is an efficient approach to combine the above-mentioned monitoring

tools. The three components of the balanced scorecard approach are:

- Goal-based monitoring, focussing on multiples of salary at retirement;
- Customised performance benchmark; and,
- Qualitative process monitoring.

The goals-based monitoring approach, using multiples of salary at retirement, will provide a clear reference to objective retirement outcomes for trustees and members which has diminished as defined benefit pensions have become less common. The customised benchmark addresses the complexity of assessing active management within TDFs and provides an unambiguous tool to measure yearly investment performance. The qualitative process monitoring system provides confidence in the process, people and systems used to deliver clear, focused and successful outcomes for clients.

CONCLUSION

TDFs continue to become more common as an investment solution, attracting significant investment flows. Their dynamic nature – encompassing multiple objectives and changing asset allocations through time – has raised challenges for performance reporting and monitoring.

The balance scorecard approach ensures that the member's interests are at the forefront of the investment management process. The final outcome for the member is constantly monitored with reference to their retirement outcome. The added value from tactical asset allocation and manager selection will be accurate and transparent. Qualitative monitoring ensures that the key personnel and processes continue to contribute to the success of the TDF.

By bringing together a goal-based measure, a dynamic custom benchmark, and qualitative indicators within a balanced scorecard framework, the performance of the TDF can be monitored in a holistic and comprehensive manner.

ENDNOTES

1. Idzorek, T., Stempien, J., & Voris, N., "Selecting a Target Date Benchmark". Ibbotson Methodology Paper, 30 September 2011.

<http://www.thecfdd.com/files/tdfbenchmarks/SelectTargetDateBenchmark.pdf>

2. Surz, R. & Israelsen, C., "Evaluating Target Date Lifecycle Funds", *The Journal of Performance Measurement*, Winter 2007/2008.

<http://targetdatesolutions.com/articles/Evaluating-Target-Date-Funds-JourPerformMeasurement.pdf>



This paper was authored by Sean Henaghan, Stephen Flegg and Simon Wood.

Sean Henaghan is responsible for the management of [AMP Capital's](#) flagship multi-manager capability, the Future Directions Funds as well as the Responsible Investment Leaders ESG Funds. He is also responsible for the multi-asset diversified fund portfolio management team. His role also encompasses oversight of the investment solutions/design function within the Multi Asset Group, which seeks to understand market trends and spearhead the development of tailored client solutions.

*Stephen Flegg is a portfolio analyst within AMP Capital's Multi-Asset Group.
Simon Wood, CFA, works within AMP Capital's Multi-Asset Group.*
