

Target Date Indexes Walk Their Talk: Choosing a Target Date Fund Index

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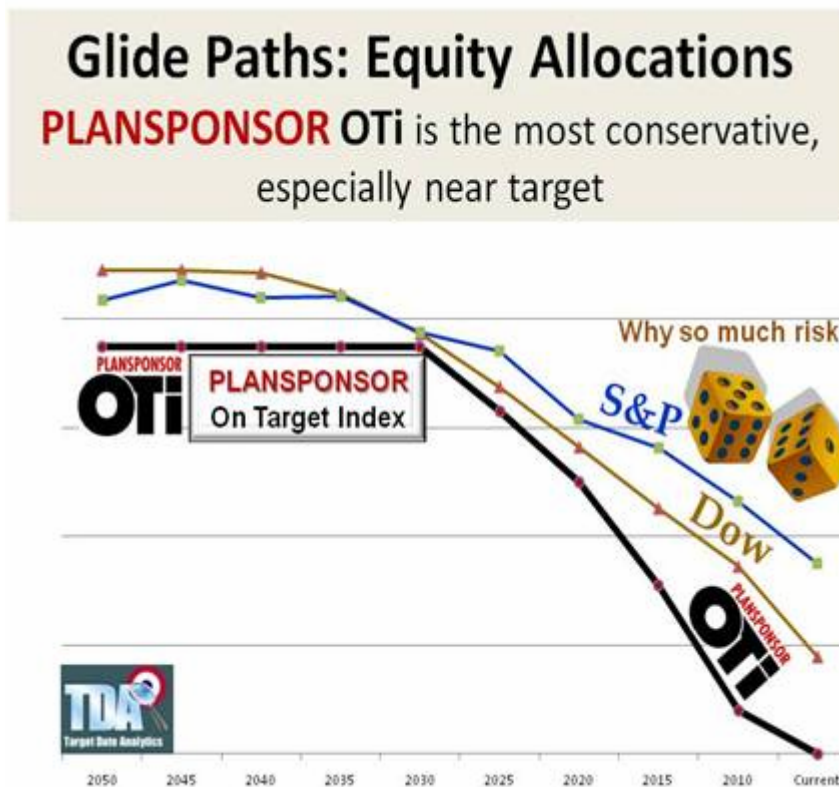
Unlike the dozens of U.S. stock indexes, there are only three target date fund indexes. Dow Jones introduced their indexes first, in April 2005. Then my firm, Target Date Analytics (TDA), introduced our indexes in October 2007. And Standard and Poor's (S&P) just announced the creation of their new indexes. Plan Sponsor magazine adopted the TDA indexes in August of this year and re-branded them as the PLANSPONSOR On Target Indexes (OTI).

These three indexes differ substantially in composition and philosophy. Let's discuss philosophy first:

- The S&P indexes are industry averages, reflecting common practices among current target date fund offerings. S&P describes this construction as follows:
"Each index is representative of the investment opportunity available to investors for the corresponding target date horizon, with asset class exposures driven by a survey of available target date funds for that horizon."
- The Dow indexes have a stated objective to: *"measure the performance of a lifecycle portfolio that seeks to grow and preserve real value over time."*
- The PLANSPONSOR On Target Indexes have two objectives: *"(1) Protect the purchasing power of contributions with a very high probability, and (2) Grow assets with a reasonably high probability, without jeopardizing the primary protection objective."*

The major difference between the Dow and OTI objectives is priority. Dow places equal emphasis on preservation and growth whereas OTI emphasizes preservation over growth. **In summary, the OTI and Dow indexes are standards – the way target date funds should be managed – and the S&P indexes are common practice aggregates.** Unfortunately, we find common practice woefully

lagging both the Dow and OTI standards. Target date funds are a great idea with awful execution, at least so far.



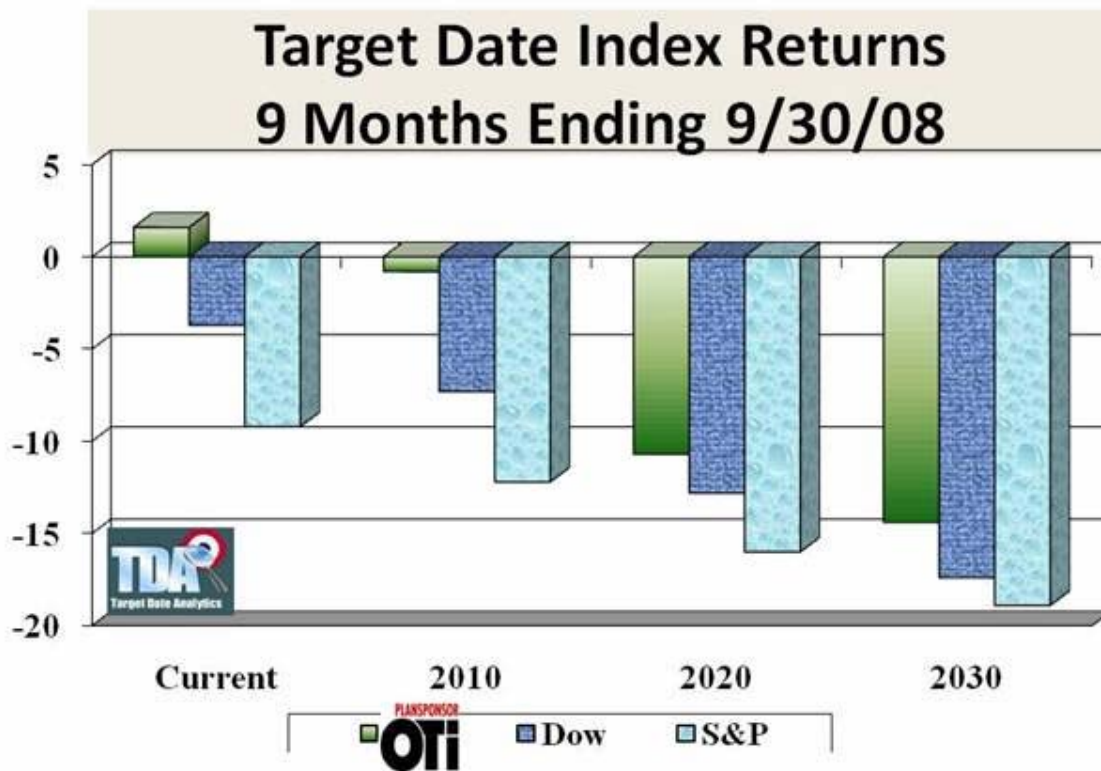
These differences in philosophy and objectives lead to materially different index compositions and results. The exhibit on the left summarizes composition differences at the broad equity allocation level. As you can see, as the target date approaches the S&P indexes are the most

aggressive, followed by the Dow, and then the PLANSponsor OTI are the most defensive. All 3 indexes are quite similar in equity allocation at the more distant dates.

There is an ongoing debate raging in the target date industry regarding the purpose of target date funds. So far it's TDA versus the industry. We at TDA believe that target date funds should be limited to the accumulation phase of a participant's lifecycle, and that the distribution phase is best served by vehicles designed for this purpose, like annuities. [Vehicles designed to address longevity risk should be employed post-retirement because there is no glide path that can handle this life-long task.](#) Accordingly, we believe that target date funds should be entirely in safe non-risky assets at target date, waiting for the participant to move to the next phase, which they should be thinking about long before retirement. On the contrary, the industry sees target date funds morphing into distribution funds at target date and continuing on, in some cases to death. This is akin to viewing the target date as a small speed bump on the highway of life. Truth in advertising dictates that funds taking this view should be re-labeled so the investor knows their intended lifespan. For example, 2010 funds that are

intended to serve the investor for 30 years beyond retirement date should be re-labeled 2010-to-2040 funds. What do you think the role of target date funds should be?

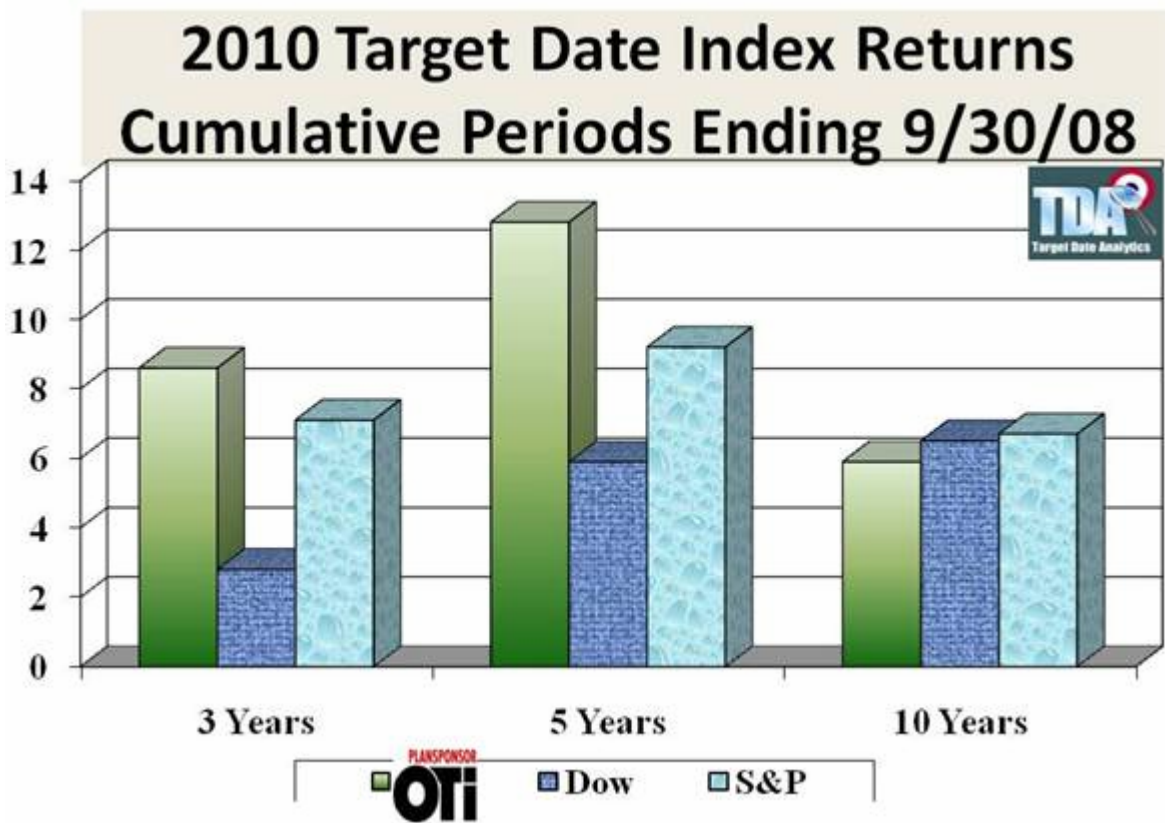
These composition and philosophical differences have significantly impacted target date index performance in the year to date, as shown in the next exhibit. The recent meltdown has been a wake-up call for the target date industry and gives TDA an “I told you so” that we wish we didn’t have. Our greatest concern is for investors in near-dated funds, who are at or near retirement, and have the most at stake both emotionally and monetarily. For the most part these 60-plus year old investors are in target date funds as a default option in their 401(K) plans, since target date funds are one of three qualified default investment alternatives (QDIAs). Do you suppose any of these folks were prepared for the kind of disastrous loss that has occurred in both the S&P and Dow indexes? Did they know the risks they were exposed to? That is, what is the better standard?



(S&P returns are approximate, and represented by TDA’s peer group indexes.)

Your choice of index makes a big difference in your evaluation of target date fund results. [Choose the index that is most in line with the plan participants' understanding of what target funds should be.](#)

But the OTI defensive posture at target date is not the only difference among the indexes. Diversification is also an important distinction. The S&P indexes are not very well diversified, comprising mostly U.S. stocks and bonds, because this is the current industry practice. The Dow indexes are somewhat more diversified, and the newer Dow real return indexes are even better. But the most diversified indexes are the OTI, representing the world market. The benefits of diversification following long-term performances of 2010 funds.



(S&P returns are approximate, and represented by TDA's peer group indexes.)

As you can see, the choice of target date index makes a big difference over longer horizons, extending back beyond the current meltdown into better times. So now you can make an informed selection.

