I. A Brief History of Target Date Funds

This is the first in a comprehensive series of articles about target date funds. In publishing this series we hope to give some badly needed perspective to the critical issues faced by target date investors, by plan sponsors and their advisors.

The first target date funds were introduced in March of 1994 by Wells Fargo and Barclays Global Investors—the two firms had some departments in common back then and when they separated Wells Fargo continued to use BGI for their glidepath management. It's important to understand *why* they created these funds. The people at Wells and BGI were responding to a demand in the 401(k) marketplace. In the eighties and nineties one issue dominated the 401(k) world—participants' failure to carry out prudent asset allocation of their retirement portfolios over their years in the plans. The response to this lack of effective self-portfolio management had been investment education. But 20-plus years of forced investment education revealed a lack of acceptance by the intended "students," the participants in self-directed defined contribution plans; e.g., 401(k) participants.

As anyone who ever conducted an employee investment education meeting knows, at the end of all the sincere charts and presentations, investors would approach the meeting leader and say, "I understand all that allocation and risk-return stuff, but would you just tell me what to do?"

While most of the industry was still trying to force feed the participants more, better, different education, the product development people at Wells and BGI were recognizing the "failure to learn" as what it really was. The participants were telling us to do it for them. After all, if we were so smart, why try to teach them how to do it; why not do it for them? The challenge of course, was how to provide a coherent investment strategy for millions of different participants.

The genius behind the creation of the first target date funds was the realization that participants could be aggregated into manageable cohorts, organized by years to liquidity (retirement), and that single piece of information was more powerful than all the other factors under consideration in portfolio construction. The goal was simply to provide a coherent strategy that would suit most investors in the retirement plan from the first day of their participation until they were ready to retire. Once the fund developers had organized allocation models into cohorts, by years to the retirement date, it was a simple matter to create a sliding allocation that would incrementally reduce risk from the early years when participants need the high growth exposure and can withstand the risk, to the latter years when preserving what has been gained becomes the more dominant consideration. (This sliding allocation was later labeled, “the glidepath.”) When the new funds reached their target date, they were liquidated and any remaining participant assets were rolled over into the fund family’s preservation portfolio waiting at the end of the glidepath. The first target date funds to mature were the Wells and the BGI 2000 funds which were liquidated upon reaching their target date.

In October of 1996, two and a half years after Wells and BGI introduced their target date funds, Fidelity rolled out their Freedom Funds. They were followed by Nest Egg in 1999, Principal in 2001, T. Rowe Price in 2002 and Vanguard in 2003. With these funds in place, the conditions for the race for td assets were set.

Until the end of 2002, the end of three years of devastating equity market losses, growth of tdf assets was mild. In the nearly nine years ending 12/31/2002 assets had risen from zero to $15 billion. But in the following five years, by the end of 2007, assets soared from $15 billion to $179 billion. By the way, the Pension Protection Act was passed in August of 2006 and the final regulations for QDIAs weren’t released until late in 2007, exposing as impossible the claims by many that the passage of QDIA regulations was responsible for the rapid growth in tdf assets.

Our belief is that the rapid growth sprang from a number of factors, none having anything to do with QDIAs.

1. 2001, Richard Thaler and Shlomo Benartzi released the findings of a study, “Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving” which gave empirical support to both default enrollment and default investing into tdf-like asset allocation funds[1].

2. 2002, when the growth spike started, was the end of three years of crushingly brutal returns in the stock market. Many 401(k) investors had been lulled, in the preceding years of the internet bubble, into believing investing was easy. By the end 2002, many of those same investors were ready to throw in the towel and were relieved to find that there were funds (tdfs) that offered to do the investing work for them.

3. Fidelity, followed by T. Rowe Price and Vanguard, began aggressively encouraging their 401(k) recordkeeping clients to include tdfs in their investment menus.

The next significant event in the history of tdfs was what we can call the Arms Race that started in 2005. With three years of strong equity markets behind them, tdf marketing had become a matter of pure performance contests, with a growing disregard for the other half of the tdf story, asset preservation in the latter years. New entrants, like the AllianceBernstein Retirement Funds came to market with extremely high equity allocations across the glidepath, and sales efforts based on their superior short-term performance. Feeling the pressure, some of the existing fund families, like Fidelity and Vanguard, found reasons to extend their glidepaths beyond the target date and to increase the equity allocations across the entire glidepath, both changes making the funds more competitive in the short-term performance race, but only by sacrificing prudent risk management for their investors as the target date approaches.

The performance-chasing and risk-management-abandonment trend continued. Over the next three years more funds came to market, almost all with higher equity allocations and extended glidepaths. And those new funds that couldn't show returns, having none, presented white papers and touted novel asset classes. One thing was common to nearly all new offerings, they forgot, or never knew, the primary responsibility of a target date fund, namely, to stand in lieu of individual management of retirement portfolios; growing assets in the early accumulation years and preserving those assets in the latter accumulation years, up to the target date.

By 2008, the stage was set for disaster and the only surprise accompanying the devastation to individual accounts was the amount of surprise expressed by market observers. Like Captain Renault (Claude Rains) in Casablanca, these market observers, pundits and legislators were *shocked* to learn that target date funds had widely divergent strategies as the target date approaches; that is, unlike the original funds, most do not connect the date in their fund name to their landing point; the point at which the glide path reaches its most conservative position.

Acting under pressure from Congress, the DoL and the SEC held their first joint hearing ever in June of 2009, to look into the "problem" of target date funds. As might be expected, the mutual fund industry showed up in force. Their message to the regulators could be distilled down to the following points. 1) There is nothing wrong with the management of these funds. 2) They need high equity allocations to offset "longevity" risk. 3) The "government" has no business regulating investments. 4) The problems all come from a misperception by investors of what target date funds are. And, 5) perhaps the fund industry could do a better job of explaining their funds to those poor addle-brained participants.

In future installments of this series, we examine the merits of each of these claims.

As of this writing, January 2011, both the SEC and the DOL have released their proposed responses to the demands to regulate target date funds, and based on the proposals, it appears they've followed the mutual fund industry's suggestions, shifting the responsibility further onto the backs of plan sponsors and plan participants.

We will also explore the consequences of that decision and more—all about target date funds—in future installments in this series.

Target Date Analytics LLC

Next article in the series: II. Are Target Date Funds a Bad Idea?

For more information about target date funds, please visit our website: www.ontargetindex.com/articles

[1] Richard H. Thaler, Shlomo Benartzi, Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, August 2001