Since their initial introduction in 1994, target date funds have evolved from a rarely mentioned investment offering for defined contribution plan sponsors, to the cornerstone of most investment menus and the most widely used options among plan participants. The last decade has seen a particularly sharp increase in target date fund utilization due to their use as qualified default investment alternatives. The growth in target date utilization has coincided with increased focus on investment management fees and a trend toward passive investment options. As a result, passive target date funds have seen tremendous growth among plan sponsors, with total market share approaching 40% across mutual fund offerings. Morningstar estimates that in 2016 nearly two out of every three dollars contributed to target date funds went into passive strategies.\(^{(1)}\)

At FIA, we work with plan sponsors who choose to use both active and passive options.\(^{(2)}\) While we endorse passive target date offerings, we believe it is important that plan sponsors understand that choosing a passive target date option is far more complicated than opting for a passive option in a straightforward, single-style strategy. This paper will highlight the key issues surrounding passive target date funds, including how they differ from active strategies and how to differentiate between passive offerings.

**Actively Choosing a Glide Path**

In other asset classes, an investor’s decision between passive and active investment options is typically driven by the cost of active management and the probability of consistent alpha generation. Investors who opt to go with a passive option pay low fees for beta\(^{(3)}\) exposure to an asset class by using a product built to track an index. The process is quite different in the target date space, where we believe there is no completely passive approach. While there are several target date offerings constructed using only passive underlying strategies, there is no single agreed upon index that a so-called passive target date option can seek to track. This is largely due to the multi-asset nature of target date portfolios and the differences in glide paths. Consider two target date offerings, both deemed to be passive, given their use of completely passive underlying strategies. The first strategy has a beginning allocation of 95% equity, which declines to 40% at the retirement date, while the second strategy has a beginning equity allocation of 90%, which declines to 25% equity at the target date. These asset allocation differences can have a major impact on both risk and return over a participant’s career.
While a committee may believe their decision to favor passive over active underlying strategies is most important, history tells us that asset allocation is typically the most significant driver of long term returns. As a result, it’s important that committees ensure they select a glide path that fits with the objectives and demographics of their participant base, whether it is ultimately built with active or passive underlying strategies.

**Asset Class Selection**

After considering the glide path, it’s important to understand what building blocks are ultimately used to populate the portfolio. The selection of asset classes to be used when building a target date suite can have an important impact on diversification. Active target date offerings can essentially allocate to any available liquid capital market in the world. We’ve seen most active suites take advantage of that in recent years, particularly in the fixed income space. Active managers have adjusted fixed income portfolios to include high yield bonds, floating rate notes, and emerging market debt in an effort to increase yields. Passive strategies tend to be more limited in their ability to allocate to extended asset classes. To continue with the fixed income example, most passive strategies are limited to exposure to intermediate term, investment grade bonds, as below investment grade and other more nuanced sectors of the fixed income market are nearly impossible to passively invest in. Asset class selection is also important to consider when differentiating between passive options. While most providers agree on exposures to domestic equity, international equity, and core fixed income, passive providers tend to differ on their decisions to include TIPS, international bonds, and commodities. While research may differ across target date managers, it is important that a committee understand the exposures a particular suite provides and ensure that it aligns with their approach to menu design.

**Active Management**

Active management in the target date suite can occur at the target date level or at the underlying fund level. At the target date level, active management tends to come in the form of tactical asset allocation decisions. Our research has found that the majority of passive target date offerings do not offer tactical management. Given that the effectiveness of tactical asset management can vary greatly, its exclusion is not necessarily a detriment. The
same can be said about active fund management at the underlying fund level, as the debate has only intensified in recent years about active investment managers’ ability to consistently produce alpha. While we certainly believe that active management can add value in many asset classes, we are also keenly aware of how difficult it can be. Given the use of target date funds as a default option, we can understand the concept of forgoing alpha opportunities in favor of decreased tracking error and lower management fees. The active versus passive debate in the target date space has evolved in recent years and is often no longer an either/or proposition. Many active target date suites have begun to incorporate passive management in some asset classes and, in some cases, have even launched new hybrid products that seek to use elements of both active and passive underlying management. With regard to both tactical asset allocation and the use of active underlying strategies, there may not be a clear answer. Much of the decision may come down to a philosophical one, and as a result, we would encourage committees to understand the tradeoffs associated with each approach before making a decision.

**Summary**

There is not a single target date solution that is appropriate for all plan sponsors. As a result, plans sponsors can benefit from the selection of both passive and active suites. It is important for plan sponsors to understand that certain decisions made by a target date provider are active in nature even if the underlying funds are passive. Passive target date funds provide broad exposure to global capital markets along a glide path at a low cost. Differences in glide path and underlying building blocks can vary significantly, and, as a result, there is no truly passive option in the target date space. We believe a plan sponsor should undertake a prudent process that thoroughly examines the characteristics and associated risk and return of a target date option, be it active or passive.

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(2) For those unfamiliar with this terminology, passive strategies seek to replicate the performance of a certain index, such as the S&P 500 Index. Such a strategy will not perform any better or worse than the index – it will, instead, essentially match the performance of the index. Active strategies, on the other hand, are strategies where a manager is actively choosing individual stocks or bonds based on the manager’s estimation that the holdings will perform well over time. Active strategies have the potential to either outperform or underperform the stated index benchmark.

(3) Beta is defined as market-related, or systematic risk. A passive strategy includes pure beta exposure, which means that the investor is exposed to broad market risk without the added component of active decisions being made by underlying managers. Alpha, on the other hand, measures the difference between a strategy’s actual performance and the expected performance based on pure market beta. Positive alpha indicates that a manager has outperformed the underlying index benchmark.
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