Target-Date Series Research Paper: 2009 Industry Survey

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Introduction

Prior to 2008, target-date funds were the pride of the U.S. mutual fund industry. Lauded for their uncommon combination of investment sophistication and ease of use, target-date funds rapidly became the fastest-growing fund category, soaking up $50 billion of net new cash flows in 2007. Target-date funds also became one of the few fund categories to enjoy official legislative support, as the 2006 Pension Protection Act specified that defined-contribution plan sponsors could automatically enroll employees into such funds while receiving so-called "safe harbor" protection.

The honeymoon ended abruptly in 2008. Losses of 25%-30% in the average short-dated target-date fund and almost 40% in the longer-dated funds shocked many onlookers. Not only plan participants who owned the funds but also plan sponsors, consultants, financial advisors, and even at times the fund companies themselves were taken aback by the severity of the decline. So too were the politicians who had favored target-date funds only two years before. In June 2009, the category that had previously enjoyed the rare distinction of legislative favor suffered the even rarer discredit of being singled out for a legislative hearing, as the Department of Labor and the SEC held a joint one-day session to address the "concern" expressed by the Senate Special Committee on Aging that target-date investors were unprepared for their funds' level of financial risk.

The Target-Date Series Research Paper: 2009 Industry Survey addresses the target-date industry's accomplishments, challenges, and drawbacks. The report first outlines the growth of the industry, then examines target-date funds from the viewpoint of best investment practices. The framework for evaluating best practices is adapted from the Morningstar Target-Date Fund Series Ratings and Reports. Its sections include Process, Performance, Portfolio, Price, People, and Parent.

The goal of this report is to clarify the current state of the industry and to outline potential areas of improvement.

History

The first target-date mutual funds were launched in the early 1990s. Early adopters included Fidelity, Wells Fargo, and the former Barclays Global Investors. Then as now, target-date funds were primarily sold to participants in defined-contribution plans. In offering a one-stop solution that bundled various investment strategies within a single fund, target-date funds followed in the footsteps of existing fund categories. A variety of balanced, asset-allocation, and so-called "target risk" funds (i.e., highly diversified funds labeled as aggressive, moderate, or conservative) were already being marketed to defined-contribution plan investors.

However, target-date funds differed from their predecessors in two ways. First, they simplified and personalized the selection decision for the participant. No longer need the participant choose among funds of different risk levels, or determine how much to put into this balanced fund or that. Instead, the decision centered on simply selecting the fund that most closely matched the investor's expected retirement date. Second, target-date funds removed the need to monitor and adjust. Since target-date funds change their investment allocations over time in the attempt to track their investors' needs, the shareholder need not make further trades. (At least, in theory.)

As with exchange-traded funds, another innovation from the early 1990s, the assets into target-date funds arrived with a trickle rather than a flood. By the decade's end, the category held fewer than $10 billion in total assets. The 2000s were another matter, however. As more fund companies introduced target-date offerings and the category became more familiar to investors, the concept took hold. By July 2009, four separate target-date fund series were larger than the entire industry had been a decade before, with the largest series, Fidelity's, commanding more than $85 billion alone.

Net Assets, Target-Date Funds, in $ millions

	Dec. 31,1999	Dec. 31, 2004	Dec. 31, 2006	July 30, 2009
Fidelity Investments	4,998	31,020	63,644	85,446
Vanguard	NA	2,650	16,448	44,836
T. Rowe Price	NA	3,570	17,257	34,748
Principal Funds	NA	1,370	5,282	12,638
American Funds	NA	NA	NA	4,814
Wells Fargo Advantage	1,001	1,155	1,287	3,215
ING Partners Funds	NA	NA	1,235	3,081
TIAA-CREF Mutual Funds	NA	13	425	2,983
John Hancock	NA	NA	25	2,501
Barclays Global Investors	485	1,206	1,881	2,383

Source: Morningstar, Inc.

The popularity of target-date funds has remained relatively unaffected by recent events. While onlookers have criticized target-date funds for their 2008 performances, investors themselves have remained very faithful to the category. Indeed, 2008 was the highest year ever for net new cash flows into target-date funds, at an estimated $57 billion. Growth in cash flows slowed during the year, increasing at 14% year over year compared with a 75% growth rate for 2007, but total flows nevertheless were higher. For 2009, cash flows are again on track to set a record, accumulating at an annualized rate of $60 billion over the first seven months of the year. In total, more than $140 billion in net monies have entered into target-date funds since the start of 2007.

Annual Fund Flows by Target-Date Category, in $ millions

	2003	2004	2005	2006	2007	2008	07/2009
Retirement Income	474	1,019	950	797	1,373	1,803	599
Target Date 2000-2010	1,666	2,725	2,976	3,427	6,551	5,730	-772
Target Date 2011-2015	-138	699	2,898	4,601	6,947	7,622	3,484
Target Date 2016-2020	1,687	3,478	3,854	5,685	9,609	10,393	5,648
Target Date 2021-2025	NA	542	2,707	4,293	6,693	8,272	5,526

Target Date 2026-2030	1,023	1,895	2,142	3,500	7,245	8,549	6,411
Target Date 2031-2035	NA	262	1,367	2,723	4,290	5,414	4,656
Target Date 2036-2040	403	1,086	1,431	2,703	4,548	5,264	5,151
Target Date 2041-2045	NA	57	342	789	1,712	2,293	2,566
Total Target Date Fund Flows	5,132	11,795	18,720	28,674	49,663	56,805	35,056

Source: Morningstar, Inc.

Process

The glide path of a target-date series is the process by which the funds decrease the equity allocations and shift toward fixed income as an investor ages. Every target-date series has a glide path, but no two are exactly alike, and the variation among series can be dramatic.

These distinctions seem to have been lost on many investors and fiduciaries. The vague, comforting language used by firms to describe their target-date fund series ("investments are adjusted from more aggressive to more conservative as a target-retirement year approaches," in the words of one typical prospectus) belies the specific and often substantial differences within the industry.

These differences became glaringly apparent in 2008, when many target-date funds performed otherwise than their investors had expected, particularly in the funds with a target date of 2010. Morningstar has found the widest range of allocations to exist in the short-dated funds, because philosophical differences among firms' asset allocators—particularly the tradeoff between addressing longevity risk by owning more stocks and easing market risk by owning fewer stocks—are starkest when investors are approaching retirement. As the chart on the next page demonstrates, 2010 funds span a startling range of equity allocations: from the 72% weighting in AllianceBernstein's fund, to the modest 26% stake in the Wells Fargo Advantage fund. Unsurprisingly, series that had higher equity weightings typically trailed the more conservative offerings in 2008.

2010 Target-Date Fund Equity Allocation % with 2008 Performance

	Equity Allocation	2008 Performance
AllianceBernstein 2010 Retirement Strategy	72	-32.79
Oppenheimer Transition 2010	70	-41.17
American Funds Target Date 2010	67	-27.34
Columbia Retirement 2010	65	-27.07
Principal Lifetime 2010	60.09	-30.15
T Rowe Price Retirement 2010	60	-26.61
Nationwide Destination 2010	59	-23.22
Goldman Sachs Retirement Strategies 2010	58	-30.26
Mainstay Retirement 2010	56.4	-21.70
John Hancock Lifecycle 2010	56	-29.42
MassMutual Select Destination Retirement 2010	54.8	-24.66
Vanguard Target Retirement 2010	54.8	-20.58
Blackrock Lifecycle Prepared 2010	52	-25.18
RiverSource Retirement Plus 2010	52	-27.07
TIAA-CREF Lifecycle 2010	52	-23.47
Payden/Wilshire Longevity 2010+	50	-26.37
Fidelity Freedom 2010	49.7	-25.22
Vantagepoint Milestone 2010	49	-17.26
Fidelity Advisor Freedom 2010	48.6	-26.50
Barclays Global Investors LifePath 2010	43.4	-16.93
State Farm LifePath 2010	43	-17.15
Schwab Target 2010	42.9	-23.60
JPMorgan SmartRetirement 2010	39.8	-21.07
AIM Independence 2010	39.11	-19.03
MFS Lifetime 2010	31.3	-14.20
Putnam Retirement Ready 2010	27	-25.88
American Independence NestEgg 2010	26.41	-9.07
Wells Fargo Advantage DJ Target 2010	25.98	-10.70

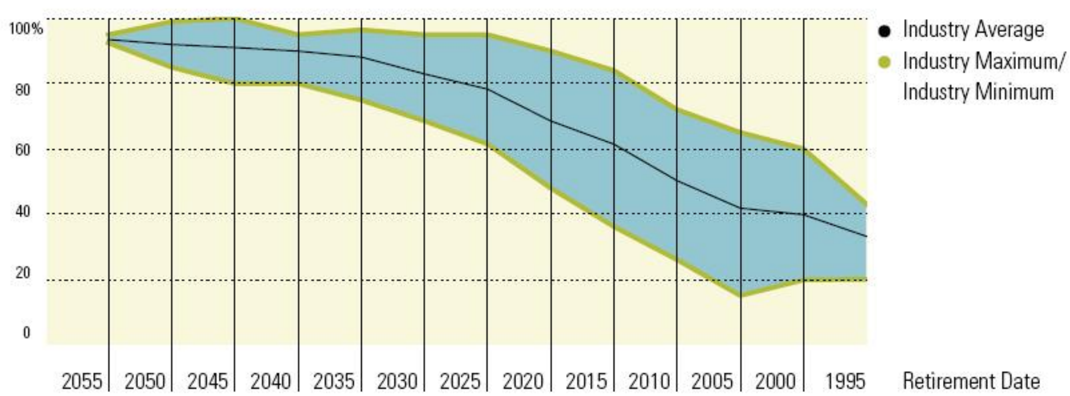
Source: Morningstar, Inc.

The next chart shows how the diversity of glide paths expands as investors near retirement. Whereas for 2050 funds, the minimum and maximum equity allocations span only 10 percentage points, for 2010 funds the range increases to 46 percentage points.

Equity Allocation % per Target Year

	Average	Minimum	Maximum
1995	20.0	20.0	20.0
2000	34.5	19.8	55.0
2005	40.4	15.0	65.0
2010	50.2	26.0	72.0
2015	62.1	36.1	84.0
2020	68.5	48.0	90.0
2025	78.3	61.5	95.0
2030	83.0	68.6	95.0
2035	88.1	75.0	96.5
2040	90.0	80.0	95.0
2045	91.1	80.0	100.0
2050	91.5	85.0	95.0
2055	93.5	92.5	95.0

Source: Morningstar, Inc.



The broad range of asset allocations and performances among the shorter target-date funds has sparked much criticism. Understandably, those funds that held the higher percentage in equities, and which therefore struggled in 2008 have borne the brunt of the 2009 criticism. However, it's worth noting that for long stretches during the history of target-date funds, those funds with higher equity positions have outperformed. There are valid academic and empirical justifications to support different approaches to constructing a glide path.

Morningstar regards the diversity of available glide paths as being a net benefit. Investors, plan sponsors, and other fiduciaries can seek target-date series that most closely match their individual preferences. These preferences include demographic factors that distinguish among different defined-contribution plans. Indeed, certain fund companies, such as TIAA-CREF and Vantagepoint, construct their glide paths to align with the needs of their particular investor bases.

That said, it is all the more crucial for fund companies to improve the transparency around their glide paths, so that investors can better understand the nature of their investments. Making such improvements would reduce the chances of mismatches between the expectations of investors and the reality of how their investments are structured. The fact that 2010 target-date funds have lost assets in 2009 despite the overall popularity of the target-date concept is strong evidence that those expectations were not always properly aligned.

There are several major areas where significant philosophical and pragmatic differences exist among the target-date series. These areas, outlined over the next three pages, are critical in fully comprehending the potential risks and performance behavior of a given target-date series and how that series compares with others in the target-date universe. Yet the disclosure and transparency on these subjects is in most instances inadequate. Even for Morningstar, it can be a struggle to get consistent information on basic glide path allocations, never mind more sophisticated data.

Longevity Risk vs. Market Risk

Longevity risk and market risk are the primary concerns for any target-date allocator. Longevity risk is the danger that the shareholder will outlive the investment, while market risk is the danger that the investment pool will decline in value. Those companies that emphasize longevity risk will tend to invest more in stocks through an investor’s lifetime, including during retirement, in order to build sufficient capital to battle inflation and avoid outliving one’s money during retirement. Conversely, those companies that emphasize market risk will generally invest more heavily in fixed-income securities, as ballast against market declines.

That said, every target-date company is strongly concerned with longevity risk when constructing its longer-date funds. All target-date companies place at least 85% of an investor’s assets in stocks in funds dated from 2045 onward. The highest allocate close to 100%.

Close to and past the retirement age, however, the range expands markedly. Firms that are more concerned about market risks begin to decrease stock allocations and raise bond holdings more rapidly in the 10 to 15 years before retirement. Such families include Wells Fargo, JP Morgan, and DWS. In contrast, target-date series that believe longevity risk is a greater concern, such as T. Rowe Price, AllianceBernstein, and Oppenheimer, maintain sizeable equity weightings well past the target date.

Shape of the Glide Path

Even among firms that share similar philosophies about longevity or market risk, the approach to shifting allocations can vary. Many glide paths roll down equity allocations in a gradual, linear fashion, producing a consistent slope. Firms that feature such glide paths include TIAA-CREF and Vanguard. Other firms maintain a steeper slope to the glide path, in which equities are kept near or above the averages in the longer-dated funds but in the decade before retirement are dramatically slashed. Finally, ING uses a stepped glide path, in which equity weightings are kept at their original target level over each 10-year period.

Sub-asset Classes

There is little consensus among target-date firms about how to approach allocating among the subasset classes. Some firms take a basic approach, starting with domestic and foreign stocks, fixed-income, and cash and then divvying up domestic stocks along Morningstar Style Box criteria. Others introduce specialized subasset classes, such as emerging-markets stocks, foreign bonds, high-yield bonds, commodities, and real estate, among others. A new wrinkle is to incorporate low-correlation or absolute-return funds that may employ a variety of complex strategies.

Typically, the specialized asset classes are intended either to provide greater diversification, and thus smooth a target-date fund's volatility or to combat the effects of inflation (as is the case with Treasury Inflation-Protected Securities). Those assuredly are benefits. However, the presence of these asset classes also generates concerns. For one thing, most firms don't adequately explain their holdings—what subasset classes they use, how much they hold in each, or why they have made their decisions. Most prospectuses show allocations only for stocks, bonds, and cash.

Moreover, the new asset classes raise questions about management's expertise. Does the firm have the necessary skill to manage these asset classes? If not, can it hire outside talent to do so? In addition, while adding specialized asset classes offers obvious benefits in terms of building an efficient frontier, the individual asset classes may contain substantial risk, as firms with large allocations to high-yield bonds, real estate, and commodities discovered in 2008.

Tactical Allocation Methods

Target-date fund series adopt three general approaches to the issue of tactical allocation, or deviations from the strategic glide path. 1) No tactical allocation allowed. These firms draw a clear line in the sand: They stick to the stated glide path, with virtually no deviation. 2) Modest deviations allowed. Some companies use their rebalancing periods as an avenue to engage in limited deviations around the strategic targets. One firm, for instance, allows its managers to delay or move up monthly rebalancing by several months, allowing under- or overweighted asset classes to persist within 5 percentage points of the target allocation. 3) Active tactical allocation allowed. These companies set aside a portion of their portfolios for active tactical allocation, of the sort engaged in by some institutional money managers and hedge funds. This sleeve may be managed by a separate group that specializes in such investing, and generally is kept within the boundaries of a certain level of tracking error. Putnam, ING, DWS, and JPMorgan are among the target-date firms that employ some level of tactical allocation.

As with other aspects of the glide path, there are valid reasons behind each approach. The practitioners of active tactical asset allocation, however, present particular challenges and concerns. First, such strategies are inherently risky. They may employ derivatives or attempt to make short-term market-timing decisions, which offer opportunities for loss as well as gain. Second, such strategies require highly specialized expertise to execute successfully—which presents a challenge for a fiduciary that must judge whether the target-date company possesses such expertise. It is difficult for an outsider to evaluate whether a target-date provider has the right skills in place. Third, transparency around tactical policies is wanting. Most investors in target-date series that use tactical allocation are unaware that such strategies are in place or are unaware of their potential risks. As with other areas of transparency, target-date providers have a lot of room for improvement.

Target to or target through?

A final area of differentiation, and one that generated a great deal of discussion at the target-date hearings, concerns whether a target-date series is created to terminate at the time of retirement or intended to provide for the rest of the investor's life. This dichotomy is sometimes referred to as "target date or target death," but more properly should be called "target to or target through." That is, the target date itself unambiguously refers to the investor's intended retirement date; there can be no argument about that. But whether the fund series is built to take the investor to the point of retirement or is built to follow the investor through that stage is less clear.

If a target-date series is structured as target to, then its allocations will typically flatline once an investor retires. If, on the other hand, the series is target through, then its glide path will generally continue to evolve past retirement, typically reaching its landing point anywhere from 10-20 years after the target date. The different approaches taken by fund companies for glide paths during retirement may stem from several sources: philosophies about longevity risk; divergent expectations about an investor's actions at retirement; or simply the lack of a methodology that addresses the post-retirement phase of the glide path.

Looking forward, more target-date fund series will extend their asset allocation research to the postretirement phase, thereby altering their target-date series to reflect glide-path updates. In the meantime, fund companies can and should do a better job of communicating their approaches to investors. As a best practice, Morningstar suggests that fund companies query investors in middle-dated funds (say, 10 years from the target date) about their preference for a target to or target through fund, then funnel them to the appropriate option. That way, conservative investors with a short time horizon will be likelier to avoid the steep losses of short-dated funds during down markets, while more aggressive investors who expect to hold target date funds over the remainder of their lifetimes will not be so dismayed by missing gains during up markets.

Conclusion

Glide paths play a highly influential role in the performance of target-date funds. There are numerous permutations of glide paths and marked differences from one target-date series to the next. Fund companies must do a better job of disclosing to investors the nature of their glide paths, along with the attendant risks and performance expectations. Glide paths will continue to evolve over the coming years as fund companies conduct more research and add newer, potentially more complex asset classes and strategies. It will be all the more critical, then, that investors, advisors, plan sponsors, and other fiduciaries gain a full understanding of glide paths' defining role in target-date funds.

Performance

There is no sugarcoating the disappointing performance of most funds in Morningstar's target date 2000-2010 and retirement income categories, which are designed for investors either near or in retirement. The two categories delivered average losses of 23% and 18%, respectively, in 2008. However, no segment of the industry avoided the pain. For all categories of target-date funds, the trailing 12-month returns through August 2009 are still in the red.

The results for longer-dated categories, though by no means satisfying, were more in line with expectations. The Target Date 2036-40 category, for example, lost an average of 38% in 2008, right around the mark for the S&P 500, which declined 37% that year. However, the target-date performance is less encouraging when compared with that of the Morningstar moderate-allocation category, which lost only 28% for 2008. The difference can be attributed largely to the widely divergent asset allocations of the two categories: Moderate-allocation funds invest on average 57% of their assets in stocks, whereas target date 2036-2040 funds average 85% in stocks. Clearly, the longer-dated target-date funds were punished in 2008 for their emphasis on building capital by investing heavily in stocks, almost without exception across the industry.

Average Returns % by Morningstar U.S. Open-End Fund Category, through Aug. 31, 2009:

	12-month Return	2008	Annualized 3-Year Return	Annualized 5-Year Return
Retirement Income	-2.96	-17.74	0.47	2.57
Target Date 2000-2010	-5.64	-22.78	-0.44	2.38
Target Date 2011-2015	-9.70	-28.09	-1.91	2.16
Target Date 2016-2020	-9.78	-29.34	-2.00	2.71
Target Date 2021-2025	-13.26	-34.35	-3.37	2.40
Target Date 2026-2030	-14.07	-35.53	-3.82	2.13
Target Date 2031-2035	-14.90	-36.93	-4.06	2.28
Target Date 2036-2040	-15.60	-37.77	-4.51	2.15
Target Date 2041-2045	-15.85	-38.08	-4.45	2.47
Target Date 2050+	-15.87	-38.70	-4.64	2.27
Conservative Allocation	-3.22	-18.87	0.29	2.44
Convertible Bonds	-6.50	-33.45	-0.32	3.14
Moderate Allocation	-9.54	-27.94	-2.07	2.29
World Allocation	-10.80	-30.13	-1.07	4.52

Source: Morningstar, Inc.

The poor returns of many target-date funds intended for investors close to or in retirement came as a greater surprise, however. This was the result of several factors. For one thing, all 2010 funds have some exposure to equities, and some have a great deal. As discussed in the Process section, firms that emphasize longevity risk allocate as much as 60% to 70% of their assets to stocks; the average allocation for 2010 funds is about 50%. Thus, even short-dated target-date funds are substantively exposed to the risks of the stock market. If investors expecting to retire within a couple of years thought that their target-date funds had converted to primarily fixed-income investments, that represented a huge mismatch between expectations and reality--and a failure on the part of the target-date fund companies to explain their approaches.

Asset allocation was only part of the story, though. In the case of underperforming 2010 funds, aggressive allocations to stocks were often exacerbated by poor performances from the companion bond funds that were intended to serve as portfolio ballast. Fixed-income funds were affected during the worst of the bear market by the seizing up of liquidity in the credit markets, the flight to quality, and the collapse of the CDO and other non-government mortgage-related areas of the market. As a result, several of the core bond funds featured in target-date funds suffered losses of 10% to 15%, or even worse. High-yield bond funds used within target-date funds also bled heavily, with losses ranging from 13% up to a breathtaking 78%. Such funds caused large problems for many 2010 and retirement income funds, which tend to rely on high-yield bonds.

The Oppenheimer Transition series, for example, was undone by Oppenheimer Core Bond (which dropped 36%) and Oppenheimer Champion Income (-78%). The troubles of those two funds amplified the impact of an above-average stock allocation in Oppenheimer Transition 2010, propelling the fund to a 41% loss in 2008 (and 26% loss over the trailing year through August 2009). Since that debacle, Oppenheimer has replaced those bond funds' management teams and overhauled their portfolios. Fund series experiencing less severe, yet still painful, fixed income challenges included John Hancock Lifecycle Retirement, Putnam Retirement Ready, Principal Lifetime, and GuideStone Funds MyDestination.

A few questions worth considering about the use of fixed-income investments in target-date funds, particularly with those funds that are nearing the stated target date and which have higher allocations to bonds:

- Is the role of fixed income in a target-date fund series to provide income, protection, capital gains, or a combination of the three?
- Does the fund's advisor truly have expertise in both government and non-government fixed income?
- Similarly, is the adviser staffed to run investment-grade and high-yield bonds?
- How does the fixed-income allocation affect the risk/reward profile of the fund?
- How can an investor reasonably expect the series' fixed-income allocation to perform in volatile markets (when protection from fixed income is particularly valuable) and in more normal conditions?

When Managers Matter

Although disappointing performances from underlying funds due to poor manager choices dragged down several target-date fund series in 2008, sometimes the opposite held true: A few series surpassed expectations because of good decisions by the managers of the underlying funds. For example, American Funds Target Date Retirement 2040 fund cobbled together a return 2 percentage points better than the category average despite a theoretically high stock allocation, largely because the fund's underlying managers let cash build up during 2008. While the glide-path decision made by the target-date allocators is the dominant factor in determining short-term performance, series that also offer topnotch underlying managers can give their investors an edge.

Shaping Future Expectations

It is safe to say that many target-date fund series were not designed to account for the severity of the 2008 meltdown. In the aftermath, the target-fund industry has been re-evaluating its fundamental approach. Several fund companies have changed their lineups' glide paths, asset mixes, and/or underlying managers. Others have re-tested their assumptions and asset class forecasts. Investors and financial advisors are also asking more questions about topics such as savings and withdrawal levels, cash and liquidity needs, and investors' risk tolerance. In theory, those efforts ought to help investors improve their plans for weathering extreme market conditions. To ensure that investors have set expectations appropriately, though, fund companies will need to communicate clearly to investors the key philosophies and practices that set their target-date series apart and that are most likely to bear on future performance.

Portfolio

Although glide paths have received most of the attention, they are not the only investment decision facing target-date funds. All funds must translate their asset-allocation choices into actual portfolio allocations. As with glide paths, there are several possible--and potentially appropriate--approaches that target-date fund series may take.

The first decision is whether to adopt a fund of funds structure. The roots of the industry lie in that direction, as the Big Three of Fidelity, Vanguard, and T. Rowe Price, which represent more than 70% of industry assets, each populate their target-date funds with existing single-strategy mutual funds. For the most part, the funds of funds model has been adopted by later entrants as well, although often the newer players have lacked a full stable of appropriate in-house funds from which to select. So in many cases the target-date families have populated their target-date funds with new shares of old funds, or even newly created funds that clone institutional accounts.

Recently, however, some fund families have experimented by doing away with the fund of funds structure and instead hold securities directly through a master pooling arrangement. Using a master pool frees the target-date funds from paying the stated fees charged by the underlying funds—a reasonable viewpoint, in that a successful target-date fund series becomes a very large investor indeed and can quite legitimately hope to negotiate lower fees than are typically paid even for institutional funds. On the other hand, it is difficult to implement such a structure when using a number of active managers. Thus, the master pooling arrangement is likely to remain a minority approach as long as active management is preferred.

On that front, the target-date industry remains strongly committed to active management. There are more target-date fund series that have essentially 100% of their assets invested in actively run funds than there are series that have even a moderate stake in passively run assets. However, the current investment popularity of indexing strategies, along with the political pressure to include more indexed options within 401(k) plans, appears to be having an effect, as evidenced by Fidelity's recent decision to offer a fully indexed target-date series.

Another decision is whether to run the assets in-house, or to use external subadvisors. Because target-date funds invest across a range of asset classes (some fairly specialized, such as commodities, global real estate, high-yield bonds or preferred securities) it is questionable whether any fund family truly possesses the expertise, experience, and resources necessary to invest each of those asset classes effectively over the long haul.

(It can be easier to assess the strengths or weaknesses of the target date fund's management in the fund-of-funds structure, because investors or fiduciaries can look to the performance of the underlying funds or managers' other charges for evidence. Discerning the skill or qualifications of management teams investing in master pools is more difficult.)

Current industry practices are quite varied. Several major fund families use all in-house funds, such as Vanguard, T. Rowe Price, Putnam, Fidelity, and American Funds. In contrast, Vantagepoint uses only third-party subadvisors, and John Hancock and Principal opt for a combination of in-house management teams and external subadvisors. The decision to outsource is not always obvious. It's logical to think that a company lacking expertise in managing a particular asset class should seek a stronger subadvisor to manage that slice of the target-date portfolio. Yet evaluating and monitoring subadvisors also requires specialized expertise and experience. The manager selection teams and processes at some target-date companies are significantly more advanced than at others.

Target Date Fund Series by Percentage of Assets in Active Strategies

	% Active
America n Funds	100.00
BlackRock	100.00
MassMutual	100.00
RiverSource	100.00
MFS	99.99
TIAA-CREF	99.93
Putnam	99.87
Oppenheimer	98.99
Principal	98.72
JPMorgan	98.59
Columbia	97.98
Fidelity Advisor	96.69
Franklin Templeton	96.05
American Century	95.23
ING	94.30
Fidelity	93.08
Guidestone	90.68
MainStay	86.29
T. Rowe Price	80.62
John Hancock	78.87
Vantagepoint	77.07
Schwab	77.00
DWS	68.20
AIM	64.52
Barclays	62.52
State Farm	61.45
Nationwide	7.14
Vanguard	2.60
Seligman	0.63

Source: Morningstar, Inc.

* Only target-date series that use a fund of funds structure are included.

Finally, even those families that use only proprietary funds take diverging paths when it comes to availing themselves of their best and most-popular funds. Fidelity, AllianceBernstein, and DWS do not offer their target-date investors many of their best managers. T. Rowe Price does better on that front, but a couple of its top managers are not employed by the target-date series--but subadvise competitors' target-date funds! The issue of the quality of the underlying funds in target-date fund portfolios will become more significant as the industry grows.

As with all else in the target-date industry, the range of quality of underlying funds as measured by the Morningstar Mutual Fund Star Rating is quite large. At the bottom of the scale, the funds that make up the Goldman Sachs target-date family have an average underlying rating of only 1.73 on Morningstar's 1-to-5 scale, while at the top Franklin Templeton, MainStay, and American Funds are each between 3.9 and 4.0.

Average Underlying Star Rating

	Star Rating
Goldman Sachs	1.73
RiverSource	2.31
Fidelity Advisor	2.81
Guidestone	2.83
Payden/Wilshire	2.86
Seligman	2.94
Vanguard	3.03
Oppenheimer	3.03
DWS	3.05
Fidelity	3.08
Columbia	3.11
John Hancock	3.11
AIM	3.13
Schwab	3.13
Blackrock	3.16
MassMutual	3.3
Putnam	3.38
Nationwide	3.40
Vantagepoint	3.46
T. Rowe Price	3.48
ING	3.57
TIAA-CREF	3.66
JP Morgan	3.71
MFS	3.71
American Century	3.89
American Funds	3.90
MainStay	3.95
Franklin Templeton	3.99

Source: Morningstar, Inc.

Price

Morningstar's research has consistently demonstrated that cost is a good predictor of fund performance, across any type of mutual fund. The lower the cost associated with a fund, the likelier it is to outperform its peers. Critically for the target-date industry, which offers funds that have the longest time horizon of any U.S. mutual fund (the implicit time horizon of a 2040 fund that is held past retirement until the owner's death is about 60 years), the advantage that accrues to lower costs increases with time. Over a few years, a high-cost fund may well enjoy enough investment fortune to outgain a low-cost fund. Over several decades, however, there have been very few actual examples of high-cost funds that have been able to outperform. The odds against them become very steep.

What's more, even a very modest performance advantage becomes sizeable when compounded over many years. To take a simple example, assume that a 25-year-old investor places $5,000 in a target-date 2050 fund, adds $3,000 to the account each subsequent year, and the fund earns a 6% compound annualized return over the next 40 years. The result would be $549,657. But invest in a different fund that earns the same total return but charges 50 basis points more in expenses per year, and the hypothetical investor would take home $480,264—a full $69,000 less.

Although target-date funds are moderately priced by the overall standards of the U.S. fund industry, they are not necessarily cheap given their large amount of assets, their status as an investment that has been semiofficially approved by the federal government, and their extremely long time horizon. On an asset-weighted basis, more than half the industry's fund series have annual expense ratios exceeding 1%. Over the years, those funds will have great difficulty keeping pace with the funds from industry price leader Vanguard.

Morningstar expects target-date fund expense ratios to decline over the next few years. The price gap between Vanguard and the other target-date series exerts constant pressure on the rest of the industry. In addition, the outperformance of low-cost exchange-traded funds over higher-cost actively managed mutual funds in 2008 has fostered a greater appreciation in the marketplace for minimizing annual expense ratios. Finally, the media and Washington legislators have asked hard questions of the costs of target-date funds, given their relatively disappointing recent performances.

Target-Date Series Asset-Weighted Average Expense Ratios

	Asset Weighted Expense Ratio %	Total Assets in Millions $	Industry Target-Date Assets %
Vanguard Target Retirement Series	0.19	41,051	21
USAA Target Retirement	0.64	512	0
TIAA-CREF Lifecycle Series	0.69	2.674	1
NestEgg Dow Jones Series	0.69	91	0
Fidelity Freedom Series	0.69	71,835	37
Harbor Target Retirement	0.70	89	0
Schwab Target Series	0.72	569	0
T. Rowe Price Retirement Series	0.73	31,998	16
Wells Fargo Advantage	0.81	2,882	1
Allianz Global Inv Solutions	0.83	186	0
Columbia Retirement Portfolios	0.83	17	0
JP Morgan SmartRetirement	0.86	1,209	1
American Century LIVESTRONG	0.88	1,472	1
RiverSource Retirement Plus Series	0.88	127	0
Barclays Global Inv LifePath Series	0.91	2,196	1
ING Index Solution	0.94	139	0
John Hancock Lifecycle Series	0.95	2,223	1
AllianceBernstein Retirement Str	0.95	1,631	1
Hartford Target Retirement	0.97	126	0
American Funds Trgt Date Rtrmt	0.98	4,321	2
Russell Distribution	0.98	8	0
Old Mutual	0.99	4	0
Vantagepoint Milestone Series	1.02	717	0
Goldman Sachs Retirement Str	1.02	75	0
Principal LifeTime Series	1.03	11,620	6
MassMutual Life Insurance Co	1.04	1,004	1
Russell Lifepoints	1.06	486	0
Fidelity Advisor Freedom Series	1.07	7,330	4
Guidestone Funds MyDestination	1.10	419	0
Nationwide Target Destination	1.11	295	0
DWS LifeCompass Series	1.13	487	0
MainStay Retirement Series	1.14	177	0
Manning and Napier Target	1.14	126	0
Putnam RetirementReady Series	1.14	250	0
Maxim Lifetime	1.15	2	0
Rayden/Wilshire Target Date Series	1.15	4	0
ING Solution Series	1.15	2,746	1
PIMCO RealRetirement	1.22	17	0
Van Kampen Retirement	1.29	47	0
AIM Independence Series	1.31	41	0
State Farm Lifepath Series	1.32	2,152	1
Legg Mason Partners Target Retire	1.34	12	0

BlackRock Lifecycle Prepared Series	1.36	36	0
MFS Lifetime Series	1.38	208	0
Franklin Templeton Retirem Series	1.44	54	0
Seligman TargetHorizon ETF Series	1.57	120	0
Oppenheimer LifeCycle Series	1.73	187	0
SunAmerica	1.82	298	0

Source: Morningstar, Inc.

Also under pressure are so-called overlay fees—management fees that some fund companies layer on top of the underlying funds' expense ratios. The existence of overlay fees is understandable with those few target-date series that hire subadvisors, as otherwise the sponsoring fund companies may have no method of collecting fees for their services rendered. (Even so, the 1.06% overlay fee levied by State Farm for its LifePath series is quite substantial.) The fees are more questionable, however, when accompanying the expense ratios of underlying funds that are managed in-house, and thus already contributing to the fund company's coffers.

Several target-date fund series, particularly the newer ones, have cut their costs temporarily through fee waivers. Such waivers are useful, but nowhere near as valuable to investors as is a permanently lower cost structure, because waivers can and will expire if the fund board does not negotiate a renewal. That's exactly what happened recently at Vantagepoint's target-date series, which increased its expense ratio by 10 basis points per annum in mid-2009 when the fund board voted not to renew the waiver.

People

Given the relative youth of the target-date industry, there is little value in examining the length of manager tenure overseeing the various target-date series themselves. However, evaluating the tenure of the managers of the series' underlying funds is more telling. Funds sponsored by companies that have high manager retention rates and long tenures are more likely to have the same target-date team in place over the next several years. Meanwhile, firms with relatively low retention rates may suffer future turmoil.

Among the fund families offering the largest target-date series, there's quite a range of experience, with the American Funds as the clear leader.

Average Fund Manager Tenure and Retention Rates

	Average Manager Tenure for underlying holdings of target-date funds, in years as of June 2009	Firm-Wide Manager Retention Rate, 5-year average % as of Dec. 31, 2008
American Funds	23.04	98.67
Vanguard	10.74	93.31
JPMorgan	8.05	85.68
Vantagepoint	7.07	91.83
T. Rowe Price	6.44	93.39
MFS	6.44	86.54
MassMutual	6.29	88.62
Principal	5.63	87.25
Putnam	5.61	78.88
Schwab	5.38	86.68
Fidelity Freedom	4.62	86.28
ING	4.13	86.91
TIAA-CREF	3.80	87.64
Oppenheimer	3.40	91.04
American Century	3.27	87.70
John Hancock	2.88	87.32
Fidelity Advisor Freedom	2.52	86.28
AllianceBernstein	2.46	89.78
Wells Fargo	2.46	89.47
DWS	2.42	82.06

Source: Morningstar, Inc.

Performance Pays (Partially)

Along with manager tenure, compensation structure is also important in understanding management's capabilities. Because target-date funds are designed to be long-term investments, it makes sense to have their managers focused on the long haul, too. Funds that pay managers to deliver strong long-term performance do the most to align the managers' own financial goals with shareholders'. Conversely, managers who are paid based on short-term returns may assume unnecessary risk so as to achieve short-term goals that are meaningless to buy-and-hold shareholders, and managers who get paid to grow the funds' asset bases may choose to go on a sales call rather than research a new investment.

Of the 20 pay plans we studied in the target-date industry, six of them base most of the managers' compensation on generating peer-beating returns over the longer term, which we define as periods of four years or more. Ten of the 20 series include longer-term performance as part of the bonus calculation, but the disclosure did not make clear if long-term performance is the primary factor for the managers' compensation. (It is possible that long-term results are only a minority item.) Disappointingly, four series received no credit at all for aligning their compensation plans with shareholders' best interests. These series offer so little detail about their pay plans in filings with the SEC that it was impossible to tell what criteria were used in determining the bonus payouts.

Main Criterion of Pay Plans

Long-Term Performance	Shorter-Term Performance	Gathering Assets or Criterion Unclear
American Funds	AllianceBernstein	ING
American Century	Fidelity	MassMutual
DWS	Fidelity Advisor	Principal
JP Morgan	John Hancock	Wells Fargo
T. Rowe Price	MFS	
Vanguard	Oppenheimer	
	Putnam	
	Schwab	
	TIAA-CREF	
	Vantagepoint	

Source: Morningstar, Inc.

Little Skin in the Game

Target-date funds are marketed as core holdings for investors, so Morningstar expected to see fund managers using these funds as the core of their own portfolios. Morningstar views best practices for fund-manager ownership as having the manager invest at least $1 million in a core fund that he or she runs. (One million dollars is the amount of the investment necessary to receive full credit for manager ownership in the Morningstar Stewardship Grades for mutual funds.) Not only does manager ownership of fund shares demonstrate conviction in the investment process and in the fees charged, Morningstar has found that managers who invest in their funds have delivered superior relative returns. Across the entire mutual fund industry, the more money a manager has placed into funds that he or she runs, the higher the total returns are likelier to be.

Manager Ownership Levels and Relative Fund Performance as of July 31, 2009

	Average Category Rank 5 years	**Number of Funds**
More than $1 million	42	413
$500,001 to $1 million	44	197
$100,001 to $500,000	46	679
$50,001 to $100,000	50	285
$10,001 to $50,000	50	393
$1 to $10,000	52	159
$0	54	2,257

Source: Morningstar, Inc., SEC filings

In the case of target-date funds, however, manager investment is severely lacking. Of the 58 named managers of the target-date series that Morningstar studied for this section, only two had investments greater than $500,000 (the lowest threshold for manager-ownership credit for a core fund under Morningstar's Stewardship Grade criteria). One (from TIAA-CREF) received the full score for having more than $1 million invested. Meanwhile, 33 managers had no investment whatsoever. The target-date managers' investments in their portfolios' underlying funds weren't much better.

Manager Investments in Target-Date Fund Shares as of the Most Recent Regulatory Disclosure

	$0	**$0 to$10,000**	**$10,001 to $50,000**	**$50,001 to $100,000**	**$100,001 to $500,000**	**$500,001 to $1 million**	**More than $1 million**
Target-Date Fund Managers	33	1	8	5	9	1	1

Source: Morningstar, Inc.

In three of the 20 plans, managers had difficulty investing directly in the target-date funds. Even so, it is telling that few target-date fund managers have demonstrated their conviction in funds by making direct investments—particularly as the public message from fund companies about target-date funds is that they, more than any other type of mutual fund, are appropriate for all retirement investors. It appears that to a large extent, the managers of target-date funds themselves are not as confident about such claims as are the companies' marketing departments.

Parent

Morningstar routinely assesses fund companies' corporate cultures as part of assigning the Morningstar Stewardship Grades for mutual funds. A culture that exhibits best practices is one in which fund managers and analysts spend their careers at the firm, sharing in investor successes or failures. If the company's funds do well, then the company attracts assets, grows its revenue, and the managers' compensation increases over the long term. If not, then not. In contrast, a corporate culture that is in flux due to a change in control, new executive leadership, a regulatory scandal, a raft of shareholder redemptions, or the inability of top management to set a consistent strategic direction is a cause for concern.

Investing in target-date funds that are supported by investor-focused corporate cultures is especially critical given the decades that investors are expected to own these investments. If a fund company's culture doesn't always put investors before profits, it's unlikely to produce a good shareholder experience. In fact, Morningstar's research has shown that fund firms with top corporate cultures merge fewer struggling funds, have higher manager retention rates, and are less likely to launch waves of trendy funds. Fund companies that receive top corporate culture grades from Morningstar also have been some of the biggest winners of target-date assets, suggesting investors are choosing firms that are good stewards of capital.

Culture Grades and Fund Mergers, Launches, Manager Retention

Fund Family	Fund mergers since 2005	Funds launched since 2005	Manager retention %, annualized since 2004	Morningstar Corporate Culture Grade
Vanguard	1	12	93.15	A
American Funds	0	3	98.64	A
Fidelity Investments	9	35	86.18	B
PIMCO Funds	0	22	90.54	B
Franklin Templeton	12	16	91.89	B
T. Rowe Price	3	14	94.13	A
John Hancock	34	127	88.80	C
OppenheimerFunds	9	16	89.15	C
Dodge & Cox	0	1	96.09	A
Columbia	45	7	86.68	C

Source: Morningstar, Inc.

Board Oversight

There is also insight to be gathered from measuring the fund boards that oversee the quality and expenses of funds on their watch. Boards are designed to act independently of the funds' advisor on behalf of shareholders and are charged with important tasks such as fund launches and closures, negotiating the funds' annual contract with the advisor, and setting the funds' fees.

In assessing fund boards, the first item of importance is determining if there is a supermajority of independent directors and independent board chairmen. Highly dependent fund boards are more likely to be overly swayed by the view of the advisor. Board members are also expected to have significant investments in the funds they oversee, as evidence that their incentives are aligned with shareholders'. Lastly, there should be evidence that the board has taken concrete steps in the best interests of shareholders by negotiating lower fees, merging offerings, or pushing for manager changes or a subadvisory contract if a fund hasn't been run well.

Among the 20 target-date fund series that Morningstar has evaluated, no boards satisfied all these best-practices criteria. Some scored highly for their independence and investments but could be doing more to serve shareholders, while others have produced good results for shareholders but fall short for independence or personal investment in the funds they oversee.

Need for Better Disclosure

As mentioned earlier in this report, one area of target-date fund stewardship that has been particularly disappointing has been the series' explanation of their strategies and operations in public disclosure. Based on the current information on fund companies' Web sites and in filings with the SEC, it's tough—if not downright impossible—for individual shareholders to understand how their target-date funds were designed and how they'll work (and may perform) going forward.

Even the series with the best current practices for disclosure—Vanguard and T. Rowe Price—have room for improvement. Target-date series would go a long way toward helping shareholders be better owners of target-date funds if they were to publish transparent, easily accessible information on the rationale that lies behind their decisions on asset allocation and manager selection.

Investors would also benefit from more detailed, timely, and useful information on target-date funds' underlying investments. Investors routinely can see a list of the funds included in the target-date offerings, but most series don't give any details on asset allocation beyond the broad stock-bond-cash allocations. If fund companies were to clearly show how the underlying funds' allocations contributed to the target-date fund's broader asset allocation, then it would be clear which asset classes were included and which were left out. If funds' actual allocation strayed from the allocation goals, it would be good to know that, too. MFS is one company to be lauded for its policy of disclosing if its current asset allocation has strayed.

With better disclosure would come a better understanding of performance—and clearer expectations. Several structural factors, including asset allocation, manager selection, and security selection, all contribute to performance, so understanding what helped or hurt a fund's performance based on current disclosures can be tricky, to put it charitably. Had target-date series been more transparent prior to 2008's slide—especially among their bond investments—investors may not have been so surprised. By setting clearer expectations, target-date funds could better avoid redemptions and regulatory hearings.

Keeping Clean

Finally, has the fund company run afoul with industry regulators? It stands to reason that firms with a strong history of compliance are less likely to encounter trouble with their target-date funds. Several of the 20 target-date series we studied most closely have had regulatory problems in the past. A few, including AllianceBernstein, MFS, Putnam, and DWS, were headline-grabbers during the industry's 2003-04 market-timing scandal and have since changed both senior management and their compliance efforts. More troubling is ING's 2006 settlement with regulators over payments that ING made to a New York teachers' union group so the group would endorse and promote ING annuity plans. The payments weren't disclosed, so the members of the group did not know they received biased advice.

Happily, many target-date parents have done a good job following both the letter and the spirit of mutual fund regulations in the past. For investors choosing a caretaker for their capital, it's not necessary—or advisable—to take on a series that's run by a parent that lacks focus on what's best for shareholders.