Twenty-five years ago, more was most definitely more in the defined contribution (DC) space. Conflating the quality of a DC plan with the number of investment options, plan sponsors devised plans with dozens of investment solutions ranging from straightforward money market funds to equity and bond funds to hedge fund-like strategies. Left to do their own dentistry, many plan participants allocated their accounts inappropriately; failed to rebalance their accounts over time; or, overwhelmed by their choices, avoided investing altogether.

Today, the mindset of DC plan sponsors has changed dramatically. Rather than paralyzing participants with too many choices, plan sponsors are lightening the load by paring back the menu of investments and including investment solutions that shift the heavy lifting of asset allocation, portfolio rebalancing and other tasks to investment managers. Chief among these investments are target date funds (TDFs), whose explosive growth has radically altered the DC landscape.

Launched in 1994, TDFs have become the workhorses of DC plans. Total assets in TDF mutual funds alone have grown from about $278 million at the end of 1994 to more than $1.2 trillion in the second quarter of 2019. Factor in TDF assets in separate accounts, collective investment trusts and customized vehicles, and the estimate of total TDF assets climbs to more than $2 trillion or about 25% of total DC assets today.

The phenomenal growth of TDF assets stems largely from TDFs’ innate appeal to participants and sponsors alike. For plan participants, TDFs relieve them of the burden of creating an asset allocation strategy and choosing the investments through which they would execute it. Put simply, having TDFs in their qualified retirement plans means participants need not act as their own investment advisors. For sponsors, adding TDFs enables them to streamline their investment offering (reducing complexity and administrative costs), while meeting their fiduciary responsibility to participants.

While the singular benefits TDFs offer investors and sponsors have driven much of the growth of TDF assets, TDFs would not be as prevalent as they are today were it not for the passage of the Pension Protection Act (PPA). Enacted in 2006, the PPA eliminated obstacles to employers adopting automatic enrollment of participants in their DC plans, in part by addressing employer fears of legal liability for investment losses suffered by participants. The PPA relieved plan sponsors from fiduciary responsibility for investment outcomes if they provided a suitable Qualified Default Investment Alternative (QDIA), such as TDFs, to anyone auto-enrolled in their plans. The combination of auto enrollment and safe harbor relief for plan sponsors paved the way for the wide adoption of TDFs.

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On the 25th anniversary of the emergence of TDFs, it is interesting to contemplate what the next 25 years could mean for target date funds. One possibility is the evolution of the TDF from a vehicle that grows savings to one that also helps participants spend what they’ve accumulated. TDFs might someday provide participants with answers to the questions on the minds of everyone contemplating retirement: How many years will my money last and how much can I withdraw each year given my retirement savings, anticipated market returns and my expected lifespan?

Another enhancement that makes TDFs more valuable to participants concerned about outlasting their money is the addition of guaranteed income options. Here, a TDF effectively converts a DC plan into a personalized defined benefit plan for participants seeking the security guaranteed income for life provides. With “the DB-ization of the DC plan,” as this concept is often described, participants would auto-save, and the TDF would auto-pay them a steady income during their retirement years.

TDFs offering guaranteed income are available now, but they have not been widely embraced by either participants or plan sponsors. One reason is the perceived high fees associated with any product that guarantees lifetime income. Guaranteed-income TDFs typically come with higher fees than other TDFs because they include a fee of 1% or more to guarantee lifetime payments. Of course, guaranteed income TDFs should cost more because they remove longevity risk from the retirement planning equation. Even so, many sponsors worry they will be perceived as saddling participants with high fees if they offer guaranteed-income TDFs. Sponsors have reason to think twice about adding higher-fee solutions to their plans given the increased fee litigation directed at a plan sponsors recently.

Fees notwithstanding, TDFs offering guaranteed income are likely to gain traction in the DC space. Participants contemplating decades in retirement naturally have concerns about outliving their savings, and guaranteed-income TDFs address that anxiety. Guaranteed-income TDFs can also help sponsors retain participants’ assets post retirement, a goal of many plan sponsors today. Finally, legislation winding its way through Congress potentially would provide safe harbor relief to plan sponsors who might want to add TDFs providing lifetime income but who have not done so due to the fear of litigation.

Naturally it is difficult to foresee how target date funds will evolve over coming decades, as the list of potential innovations is endless, but one thing is certain: the benefits target-date funds present both to plan participants and sponsors ensures they will play a dominant role in building comfortable retirements for years to come.
High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some durations and are more likely to cause fluctuations in a Portfolio’s income distribution. Investing in real estate poses risks related to an individual property, credit risk, and interest rate fluctuations. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio’s income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.