

## TARGET DATE FUNDS

**[HOST]:** Thank you for joining us for our podcast on Target Date Funds. With us today is Susan Czochara, Senior Product Manager of Defined Contribution Solutions for Northern Trust Global Investments. This podcast will be of particular interest to plan sponsors who are considering the addition of diversified portfolio's as investment options within their 401(k) plan.

Susan, can you begin with a general market background describing the drivers of the significant increase in demand for target date funds?

**[SUSAN]:** While target date funds have been in existence for several years, the recent surge in interest is a result of the Pension Protection Act which was signed into law in 2006. This new regulation provides incentives for plan sponsors to implement auto-enrollment within their 401(k) plans and further clarifies the appropriate qualified default investment alternatives. Target date funds along with other diversified or balanced funds are included as one of the approved qualified default investment alternatives. Overall, the Pension Protection Act is encouraging plan sponsors to reevaluate their current investment options and, as a result, target date funds are seeing a lot of growth.

**[HOST]:** So, how do target date funds differ from other diversified or balanced funds?

**[SUSAN]:** Typical balanced funds have a set allocation to bonds and equities or other asset classes that remain static over time except for occasional rebalancing. For example, a plan participant invests in a balanced fund today which has a current allocation of 70% equities and 30% bonds. Ten years from now, their allocation may have changed slightly based on market conditions but will not have changed in terms of the risk and return profile. Target date funds differ in that asset allocation does change over time based on a glidepath becoming more conservative as the investor approaches their target date, which typically represents their retirement date. Taking the first example, a participant invests

in a target date fund today with an allocation of 70% equities and 30% bonds. Ten years from now in a target date fund, the allocation will have changed to 60% equities and 40% bonds reflecting a more conservative risk and return profile.

**The benefit of target date funds is that the participant can buy one diversified fund and remain invested in it over a long period of time. The fund itself is designed to adjust its risk profile over time to fit the participant's investment horizon.**

[HOST]: You mentioned the asset allocation changes are based on a set glidepath. What is a glidepath?

[SUSAN]: A glidepath is the change in a target date fund's asset allocations over the investor's time horizon. Typically, the glidepath is depicted graphically to show investors their asset class allocations at various stages of their life.

[HOST]: Susan, what should plan sponsors look for in evaluating a target date fund's glidepath?

[SUSAN]: The first consideration is the number of asset classes that are included. Typically, a well diversified portfolio will have between 8 and 12 asset classes represented.

Second is the asset classes that are selected. It is essential to make sure the line up of asset classes are globally diversified including both developed and emerging international exposure. In addition, inflationary hedge asset classes such as commodities or tips should be included.

**Last and most importantly, the glidepath should be constructed using both historical market information and forward looking market assumptions. While glidepaths set asset allocations 50 years into the future, it is important to recognize that an asset allocation set today may not be appropriate 50 years from now.**

**Therefore, the glidepath should be dynamic in nature with the flexibility to adapt as financial market conditions change.**

**[HOST]:** Once the glidepath is constructed, how's it implemented?

**[SUSAN]:** The most common way an investment manager will implement the glidepath or asset allocation strategy is using a fund of funds structure utilizing either mutual funds or collective funds. Typically, target date strategies have been implemented using all active or all index funds. However, hybrid structures also exist combining active or enhanced strategies with index ones to provide incremental return in a cost effective manner.

**[HOST]:** Wow, it sounds as if there are a lot of target date fund choices in the market. Susan, you indicated both mutual funds and collective funds are available, can you describe the difference?

**[SUSAN]:** While historically the main difference between the fund types was valuation frequency with mutual funds being daily valued and collective funds being weekly or monthly valued, most collective funds are now daily valued also eliminating that difference. In fact, now both collective and mutual funds are supported operationally in the same way utilizing the same trade communication and settlement platform. Aside from valuation there remain a couple of differences:

First, mutual funds are regulated by the SEC while collective funds are regulated by the OCC or state regulatory agency depending on the banks charter.

Second and most importantly, the pricing on mutual funds is static regardless of amount of assets invested in the fund. Collective funds, on the other hand, offer flexibility in pricing enabling fees to decrease as assets invested in the fund increase. **I'd like to stress that pricing is the main differentiator between the two types of funds which is causing plan sponsors to consider switching from mutual funds to collective fund**

**vehicles. In fact, many plans that are currently using collective funds for their defined benefit plans can actually implement the same collective fund provider for target date strategies bundling the assets and pricing, thus reducing overall fees on both plans.**

**[HOST:]** Thank you, Susan for this insightful podcast on Target Date Funds.

**[SUSAN:]** It's been my pleasure.

**[HOST:]** If you'd like additional information on Target Date Funds please contact your relationship manager or Susan Czochara at 312-557-1825. To hear future podcasts from Northern Trust, please visit Northern Trust dot com slash podcasts to subscribe.

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