Summary
- Target-date funds (TDFs) are mutual funds that follow a glidepath investment strategy, working towards the investor retiring at a set date.
- In the US, TDF assets have grown from $116 billion to $765 billion over the past 10 years. Nine out of 10 DC plan sponsors offered TDFs in 2015, up 14 per cent compared to 2010.
- TDFs are valued for their simplicity, flexibility and governance. However, employers and trustees may be concerned at the loss of 'control' over asset allocation.
- The UK TDF market has been negligible, but pensions freedoms has sparked some growth and new entrants to the market.
- Along with the UK DC market, TDFs are expected to gain traction within the retail pensions space.

USA style

Target-date funds are popular in the US but have yet to catch on in the UK. However, following pensions freedoms, will TDFs become the solution of choice for people to invest 'to and through' retirement? Laura Blows finds out

Considering the US is the largest pensions market in the world, it is somewhat surprising to note that the most popular pension investment style in the US has barely made ripples across the pond.

Target-date funds (TDFs) are mutual funds that follow a glidepath investment strategy, working towards the investor retiring at a set date. Unlike a lifestyle fund, which involves the individual saver's money being moved in and out of the various asset classes, a TDF enables the investor to stay within the one fund, with its underlying asset classes adjusted accordingly as the fund heads towards its end date. The asset mix is also determined by what the TDF is aiming towards – cash, annuities or drawdown (in which the investor can stay invested within the TDF) – when the target date is reached.

US popularity

The popularity of TDFs in the US is immense. According to *Morningstar's 2016 Target-Date Fund Landscape*, TDF assets grew from $116 billion to $765 billion over 10 years.

Morningstar's research on the US market acknowledges that it is too soon to tell if TDFs – designed as 60-year-plus investment strategies – will successfully help investors reach retirement readiness. There are hints of a victory though, it states, as "their annualised asset-weighted average investor return is 0.7 percentage points higher than the funds' average total returns for the past decade through the end of 2015. Most other broad investment categories have negative return gaps".

Vanguard's *How America Saves 2016* finds that, in the US, nine out of 10 DC plan sponsors offered TDFs in 2015, up 14 per cent compared to 2010. Ninety-eight per cent of the survey's participants are in schemes offering TDFs, with 69 per cent of respondents using the funds.

An important factor driving the use of TDFs in the states is their popularity as default funds. However, Vanguard's research shows that TDFs are a popular choice amongst savers themselves, as only half of TDF investors entered the funds through default arrangements; the rest actively choose to invest using TDFs.

TDFs popularity over lifestyle strategies in the US can also be attributed to 'Safe Harbour' legislation, which means that an employer selecting TDF as the company pension's default fund is protected from being sued in the event of poor investment outcomes. As BlackRock managing director, strategic product management, Becky Tilston-Hales explains, in the US TDFs are "almost a 'government endorsed' strategy for pension funds".

TDF versus lifestyle

TDFs have a number of benefits, beyond litigation protection, that have made them a popular choice in their own right.

TDFs are valued for their simplicity and their flexibility, as the fund manager can quickly adjust the underlying asset mix. However, employers and trustees may be concerned at the loss of 'control', having to hope the asset allocations within the TDF that the fund manager chooses suit their members requirements.

"Trustees and sponsors value the built-in governance, which means that the target-date strategy will evolve with changing member needs, regulations and investment market conditions," State Street Global Advisors senior DC investment strategist Alistair Byrne says. "They also value that the funds are simple to administer and relatively easy to communicate to members."

However, according to Royal London pensions investment strategy manager Lorna Blyth: "Advocates of TDFs claim they are more dynamic than lifestyle funds, as they have a 'more rigid approach'. The reality is that both deliver a means of moving from one asset mix to another, over a period of time, to meet risk requirements. The key difference is just the structure."

So the choice between lifestyle and target-date funds could simply that: choice. Each has pros and cons depending on the need of the investor, rather than one being inherently better than the other. So why aren't TDFs and lifestyle funds equally enjoying the spoils of the UK market?

Platforms

The take up of TDFs within the UK occupational pensions seems negligible – so low, for example, that Morningstar was unable to provide any data when requested. One issue cited as possibly holding back the growth of TDFs in the UK is their limited availability on DC investment platforms.

As a TDF is required for every year (or cluster of years) end date, a lot of different TDFs need to be available. This can make TDFs quite difficult to manage on an investment platform, particularly as they are geared up for the more popular lifestyle strategy. "The platforms need to catch up and get the infrastructure right for the new world," Redington director, head of defined contribution, Lydia Fearn advises.

Mobius Life institutional distribution director Craig Brown notes that his investment platform company has not encountered any concerns that investment platforms in the UK are unable to manage TDFs. "We manage TDFs and whilst their management on an investment platform is more involved than lifestyle funds, both approaches are based on fund blending, which is our core capability," he states.

Signs of change

Hampered by investment platforms or not, lately there have been sparks of life from the UK TDF market.

Providers that have been offering TDFs for years are now seeing an increase in activity, due to pensions freedoms reforms requiring simplistic 'to and through' retirement saving products.

For instance, "this year we have onboarded two new TDF clients who have converted from a lifestyle approach, and we are in discussions with a number of other schemes who are considering such a move," Byrne says.

'Heavy weight' US TDF providers, such as J.P. Morgan and Vanguard, recently entered the UK market, and AB lead portfolio manager, multi-asset solutions, EMEA, David Hutchins finds that "large numbers of new employees joining DC schemes are now going into TDFs". Also, new pension schemes set up for auto-enrolment may use TDFs as their default fund, Fearn notes.

One such example of this is the National Employment Savings Trust (Nest). According to Nest director of investment development and delivery Paul Todd, Nest's TDF structure allows it to easily manage money appropriately over the whole of an individual's time saving, including making the call on when to move the saver's pot from risky to less risky asset classes.

"This is unlike traditional lifestyling where the re-balancing of assets happens automatically each year. Because TDF managers can make judgments on what action will best keep the saver on track, this can mean more thoughtful movement between assets," Todd says.

This can also mean lower transaction costs, and there are clear communications advantages to having clearly named single-year TDFs, he adds.

Uses of TDFs

Todd acknowledges TDFs 'make sense' for Nest, as it has the size and scale to create its own TDFs tailored to its members; smaller schemes without the ability to do so may come to a different conclusion about using the funds. In contrast to Nest's size, Tilston-Hales notes that in BlackRock's experience, it is commonly small- to medium-sized schemes beginning to utilise TDFs.

While Fearn does not think trustees would want the responsibility of managing TDFs for members post retirement, for employers with contract-based DC, TDFs can be a 'nice, neat', low-governance solution to enable a member to move through into retirement.

Another area of possibility is the retail space. The structure of TDFs, with its easy-to-understand structure, could make it popular within ISAs (particularly as the upcoming Lifetime ISA will be geared towards long-term saving), and the "clear benefits of TDFs in the robo-advice space" means Hutchins believes "the take up in the UK retail space is set to follow the strong growth seen in UK DC pensions".

However, its success would depend upon effective engagement, otherwise people may end up in a TDF that does not match their needs, Intelligent Pensions head of pathways Andrew Pennie warns.

Despite the ways in which a TDF could be implemented in the UK, Blyth is sceptical of how much success TDFs can really have here. "I believe that lifestyle strategies will remain a more popular choice simply because they can deliver a range of outcomes and choice of risk levels on a more cost-effective basis than TDFs," she says.

It is doubtful that TDFs will seriously challenge lifestyle funds as the default of choice anytime soon. Yet the increasing need for 'to and through' retirement savings products, plus the requirement for simplicity to encourage member engagement, makes it more likely that the UK pensions market will find room to welcome this US approach.

Written by Laura Blows