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2011 Callan Target Date Fund Survey

The Evolving Target Date Fund

- Callan surveyed nearly 30 target date fund managers regarding their management approaches, glidepaths and anticipated changes.
- Notable differences persist between target date funds in glidepath design, however performance differentials were modest in 2010.
- More than half the target date fund providers changed their glidepath as a result of a recent evaluation. The most common changes include the addition or increase of inflation-sensitive assets and/or measures taken to enhance diversification within existing asset classes.

Introduction

Touted as simple solutions for defined contribution plan participants, target date funds are a comprehensive tool to help employees save for retirement. However, these funds are not a commodity, and substantial differences exist. To learn more about the funds' nuances, Callan fielded the Target Date Fund Manager Survey in March 2011. Twenty-six target date fund managers, reflecting the experiences of 35 unique target date series,[1] responded. Nearly two-thirds (62.9%) of the target date strategies represented in the survey are actively

1 A unique target date series refers to a target date fund that is managed with a distinct asset allocation and management approach. For example, some target date fund managers offer active and passive target date series. Inasmuch as the active and passive versions are managed differently, they are considered unique target date series. However, if a manager has a target date series with multiple share classes that all feed into a single asset allocation and management approach, the share classes do not constitute unique series.

Authored by Callan Associates Inc.

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managed, while 20% are passively managed. Seventeen percent are classified as hybrid—a combination of active and passive **(Exhibit 1)**.

Target date funds vary widely by glidepath design (or asset allocation) and equity roll down (the pace of the decline in total equity exposure as the investor ages). **Exhibit 2** illustrates the equity roll downs of target date fund glidepaths (the equity allocations across the target date series) for the managers reflected in the survey. The black line represents the Callan Target Date Glidepath Index, which is an equally weighted index of the available target date fund series, developed by Callan to provide an objective benchmark showing typical target date glidepath performance. As expected, the glidepath represented by the Callan Target Date Glidepath Index falls somewhere in the midpoint of the sample glidepath roll downs.

Exhibit 1 Use of Active versus Passive Management

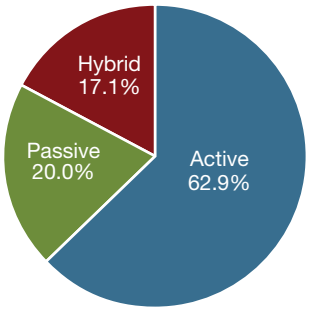
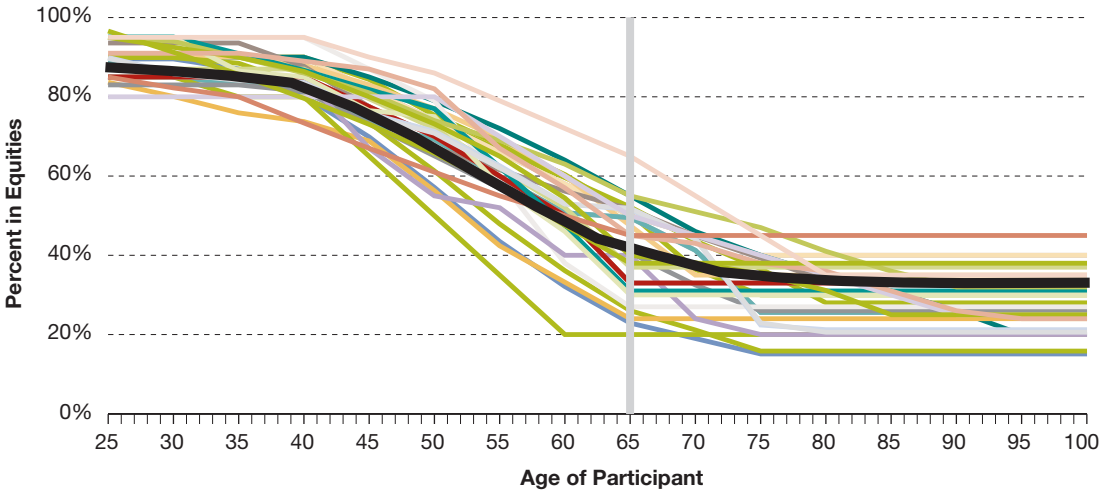


Exhibit 2 Target Date Fund Glidepath Equity Roll Downs



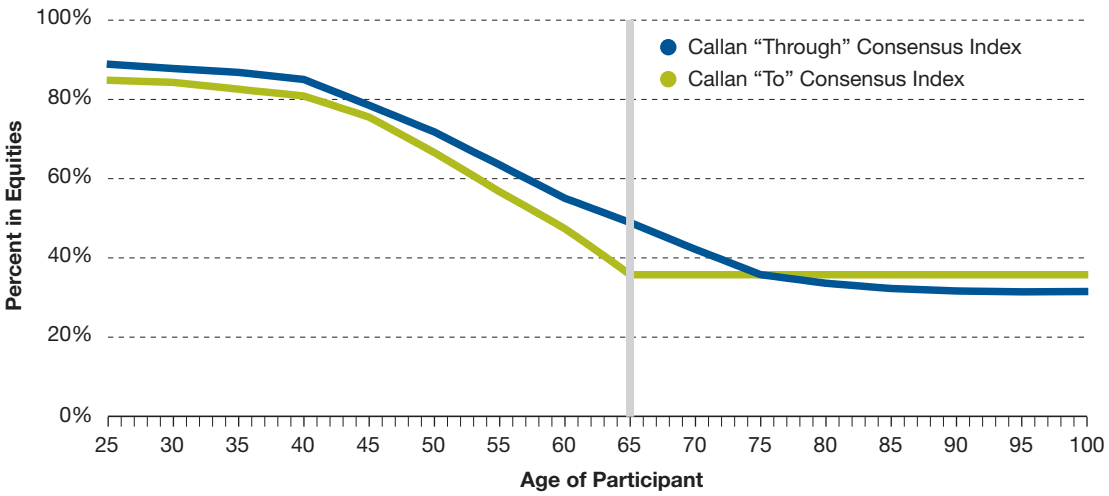
As Exhibit 2 illustrates, the target date funds in the survey demonstrate marked differences, both in terms of the equity exposure in any given target date fund series and with respect to the equity roll down of the glidepath.

Across all target date funds surveyed, and within the Callan Target Date Glidepath Index, most long-dated 2050 funds' equity allocations fall in a range of about 15 percentage points, from 80% in equities (most conservative) to 95% (most aggressive), with an average equity allocation of 87%. Near-dated 2010 funds have an average equity allocation of 44% and a generally wider span between aggressive (55% in equities) and conservative (20% in equities) glidepaths of about 35 percentage points.

To Versus Through Glidepaths

Exhibit 3 shows the average equity roll downs of "Through" and "To" retirement target date funds in the Callan Target Date Glidepath Index. Through glidepaths continue to roll down after age 65 while To glidepaths become static after age 65. Across the universe of survey respondents, two-thirds (65.7%) of the glidepaths are managed Through and the remainder are managed To retirement.

Exhibit 3 Through versus To Equity Roll Down of Callan Target Date Glidepath Index



The most notable difference between the two target date glidepaths is in the equity allocation around retirement. At age 65, the average Through glidepath has 13% more in equities than the average To glidepath (48.9% and 35.8%, respectively).

In examining the range of target date fund glidepaths, the differences between To and Through glidepath roll downs is even more notable. **Exhibit 4** shows that the span of equity allocations for long-dated 2050 funds is larger among funds managed To retirement than Through. Conversely, in near-dated 2010 options, Through-managed funds had greater variability in equity exposure and higher overall allocations to equity than their To counterparts.

Exhibit 4

Long-Dated (2050 Funds) Equity Allocations

	10th Percentile	90th Percentile	Difference
All	72%	95%	23%
To	67%	95%	28%
Through	83%	95%	12%

Near-Dated (2010 Funds) Equity Allocations

	10th Percentile	90th Percentile	Difference
All	26%	56%	30%
To	27%	49%	22%
Through	29%	63%	34%

a For long-dated Through funds, the range is fairly narrow, with aggressive long-dated funds' equity allocations ranging as high as 95% and their conservative counterparts as low as 83%.

b In contrast, while long-dated To funds share the same level of equity allocation at the aggressive end of the range (95%), the more conservative funds' equity allocations are considerably lower (67%) than Through funds.

c Through funds' range (34%) is substantially larger than To funds' (22%).

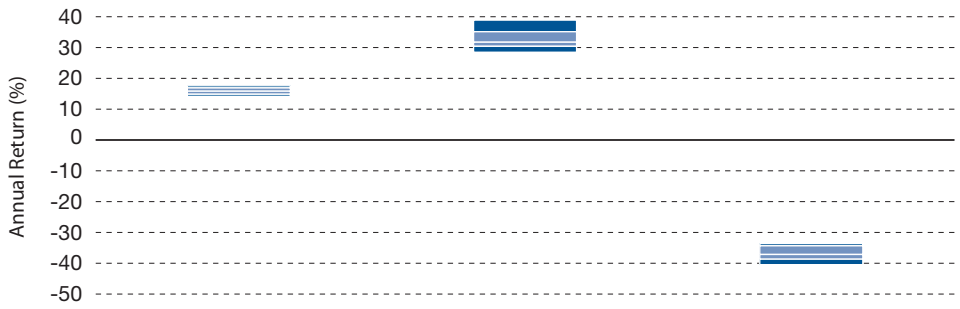
d The most aggressive Through near-term glidepath has 63% in equities and the most conservative 29%.

e To near-dated glidepaths' equity allocations at the conservative end of the spectrum are quite similar to that of their Through counterparts (27%), but at the aggressive end of the spectrum they do not surpass 50%.

Long-dated To and Through funds share the same upper equity allocation boundary and near-dated funds have a similar lower equity allocation boundary. Clearly, funds managed To retirement are not always more conservatively managed than those managed Through retirement.

The variation in equity allocations plays out in terms of performance differentials between various target date funds. **Exhibit 5** shows that the range of performance between the 10th and 90th percentiles for long-dated 2050 funds was most pronounced during the initial market rebound. Tenth percentile 2050 funds gained 38.9% in 2009 while those in the 90th percentile climbed only 28.5%. More recently, 2050 fund performance has converged—the performance differential between the 10th and 90th percentile was a mere 3.4%

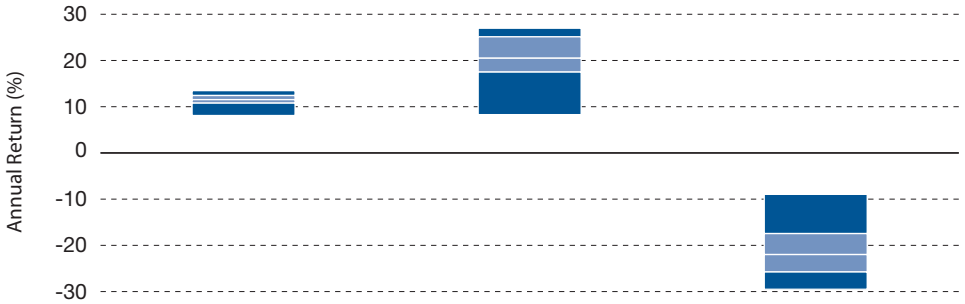
Exhibit 5 **Returns for Various Periods**
Callan Target Date 2050 (Long-Dated Funds)



	Year Ending 12/31/2010	Year Ending 12/31/2009	Year Ending 12/31/2008
10th Percentile	17.6	38.9	-33.6
25th Percentile	16.9	35.1	-34.3
Median	15.8	31.7	-37.2
75th Percentile	14.8	30.4	-38.7
90th Percentile	14.2	28.5	-40.5

in 2010. Performance ranges also narrowed for near-dated funds. While 2010 funds saw significant deviations in 2008 (10th percentile funds lost 9% while 90th percentile funds fell nearly 30%), in 2010 the difference between the 10th and 90th percentiles was only 5.4% **(Exhibit 6)**.

Exhibit 6 **Returns for Various Periods**
Callan Target Date 2010 (Near-Dated Funds)



	Year Ending 12/31/2010	Year Ending 12/31/2009	Year Ending 12/31/2008
10th Percentile	13.5	27.0	-9.0
25th Percentile	12.4	25.1	-17.5
Median	11.5	20.5	-22.0
75th Percentile	10.8	17.5	-25.8
90th Percentile	8.1	8.3	-29.5

Exhibit 7 shows the difference in performance between both near- and long-dated Through and To target date funds.

Exhibit 7

Differences in Long-Dated (2050) Through versus To

	2010	2009	2008
10th Percentile	-0.7%	-5.3%	-1.5%
Median	-0.5%	-0.7%	-0.9%
90th Percentile	-0.7%	0.7%	-0.7%

Differences in Near-Dated (2010) Through versus To

	2010	2009	2008
10th Percentile	1.2%	4.4%	-25.4%
Median	0.7%	2.5%	-6.6%
90th Percentile	-0.6%	14.1%	-9.1%

ⓐ The variance between 10th percentile long-dated Through and To funds (-1.5%) was far less notable in 2008 than for near-dated funds (-25.4%). In 2010 the difference declined for both long-dated (-0.7%) and near-dated (1.2%) funds.

ⓑ In 2008, at the 10th percentile, near-dated Through funds underperformed near-dated To funds by 25.4%; Through funds in that percentile lost 18% while To funds in that percentile actually gained 7.4%.

ⓒ In 2010, the difference between the funds was a mere 1.2%.

The variability of performance is not strictly due to differences in overall equity allocations, but also reflects divergent investment practices within the underlying equity and fixed income portions of the fund. **Exhibit 8** shows the Callan Target Date Glidepath Index's asset allocation through the glidepath.

The Index shows that, on average, target date funds have a 3.0% allocation to real estate (REITs and private real estate) throughout the glidepath. However, **Exhibit 9** reveals that less than two-thirds of target date funds in the survey have REIT allocations within their glidepath, and far fewer have private real estate. REIT exposure can range as low as zero and as high as 15% across glidepaths.

Exhibit 8 **Callan Target Date Glidepath Index Asset Allocation**

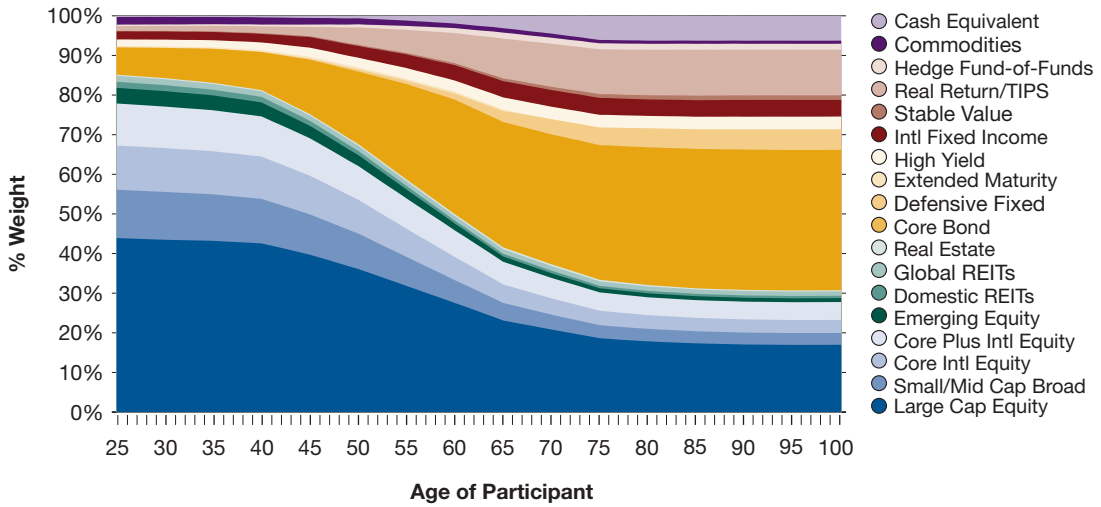


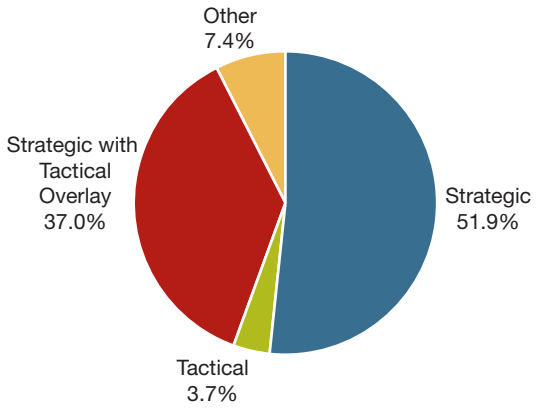
Exhibit 9 **Callan Target Date Glidepath Index Asset Allocation Details**

	% of Target Date Funds with a Stand-Alone Allocation to the Asset Class in the Glidepath	Callan Target Date Glidepath Index Allocation	Highest Allocation
TIPS	86%	7.0%	45.0%
High Yield	69%	2.4%	14.0%
Emerging Markets Equity	60%	1.5%	10.5%
REITs	63%	2.5%	15.0%
Non-U.S. Fixed Income	49%	2.7%	20.0%
Commodities	37%	0.6%	15.0%
Private Real Estate	3%	0.5%	7.0%
Alternatives	6%	1.0%	1.8%

Target Date Fund Management Approaches

Callan's 2011 Target Date Fund Survey focuses on the evolution of target date managers' glidepaths. As such, it is important to recognize that most respondents (89%) characterize their asset allocation approach as strategic in nature. Given that the majority of target date funds are managed in a long-term strategic fashion, substantial changes to the glidepath structure among target date funds should not be common. However, more target date managers have shifted to a strategic approach that incorporates a tactical overlay with small short-term deviations from the stated strategic asset allocation over the past several years. In 2011, 37% identified their approach this way versus 24% in 2009. Meanwhile, the portion of target date managers that considered their approach purely strategic dropped to 51.9% in 2011 **(Exhibit 10)** from 64% in 2009.

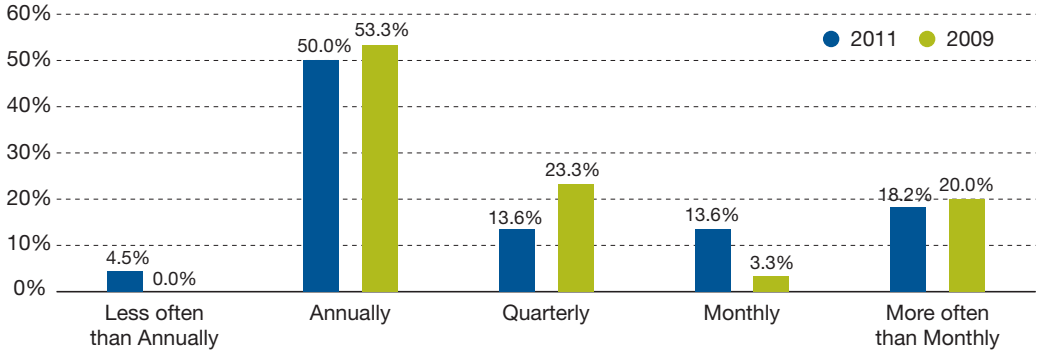
Exhibit 10 Asset Allocation Approach



Glidepath Evaluation and Changes

Half of target date fund managers evaluate their glidepaths annually, down slightly from 2009 (53.3%). More pronounced was the shift from quarterly to more frequent evaluations—likely reflecting the increase in tactical overlays. Whereas nearly one-quarter (23.3%) of managers reported quarterly evaluations in 2009, only 13.6% did so in 2011. Monthly evaluations rose from 3.3% to 13.6%. Slightly fewer managers reported evaluating their target date fund glidepath more than monthly—18.2% in 2011 compared with 20% in 2009 **(Exhibit 11)**.

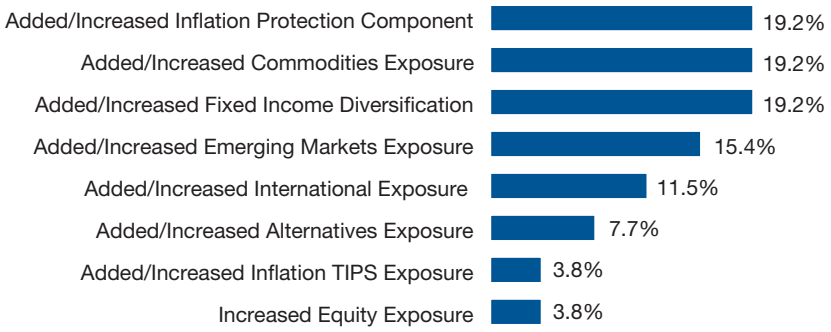
Exhibit 11 Frequency of Glidepath Evaluation



A majority of managers (58.3%) made changes to their glidepath as a result of their most recent evaluation—a significant increase from 2009 (34.5%).

Glidepath changes rarely involved dramatic modifications to the proportion of equities within the glidepath. Instead, the vast majority of changes generally fall into two categories: adding inflation-sensitive assets and enhancing diversification within asset classes. **Exhibit 12** summarizes the changes respondent firms have recently made.

Exhibit 12 Reported Changes to Glidepath



Across the 26 target date fund providers surveyed, all but four incorporate some form of inflation-sensitive assets into their glidepath. The majority of target date series maintain exposure to a combination of inflation-sensitive assets that may include TIPS, U.S. REITs, international/global REITs, commodities and/or diversified real asset portfolios.

The desire for improved asset class diversification and reduced volatility also contributed to recent glidepath changes. Several firms increased international equity exposure at the expense of domestic equity. Others added or increased emerging markets exposure given the continued move to adopting the MSCI ACWI ex US Index as the international benchmark. Within fixed income, notable additions include a mortgage fund, global bonds, senior loans as a strategic allocation and increased high yield bond exposure.

Of course, exposure to a given asset class does not always equate to a substantial commitment to that asset class **(Exhibit 13)**. For example, while 60% of target date glidepaths have exposure to emerging markets equity, the total average allocation when offered is just 3.3% (6.4% for long-dated funds and 2.7% for near-dated funds). Further, the way that asset class exposures are attained can also vary. For example, reported commodities exposure includes derivatives, equities of producers and commodities' index funds.

Exhibit 13 Average Allocations where Asset Classes are Offered

	Total* Average	Long-Dated Funds Average	Near-Dated Funds Average	Prevalence
TIPS	9.3%	5.1%	12.6%	86%
High Yield	4.0%	18.7%	4.8%	69%
Emerging Markets Equity	3.3%	6.4%	2.7%	60%
REITs	1.7%	5.2%	3.2%	63%
Non-U.S. Fixed Income	6.9%	6.0%	8.4%	49%
Commodities	3.5%	5.6%	3.3%	37%
Private Real Estate	7.0%	7.0%	7.0%	3%
Hedge Funds	23.5%	8.0%	32.2%	6%

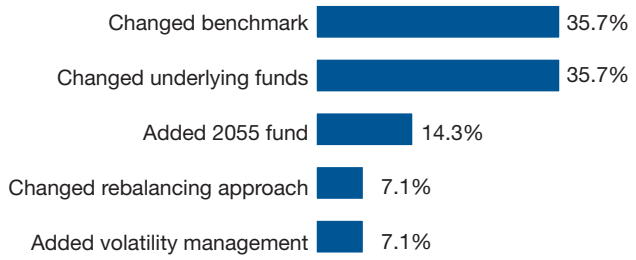
*Total funds include long-dated funds, near-dated funds and funds with varying timeframes in between.

Other Target Date Fund Changes

More than half (57.7%) of the target date managers surveyed indicate they also made changes beyond alterations to the glidepath in the past year.

A change in the fund's overall benchmark and a change in underlying funds were most commonly cited **(Exhibit 14)**. The two go hand in hand. The majority of funds (64.5%) continue to use a proprietary benchmark, which varies with glidepath and underlying fund modifications. Underlying fund changes ran the gamut, including the introduction of new asset classes, fund replacements and expanding or consolidating the number of funds in the glidepath.

Exhibit 14 Other Target Date Fund Changes

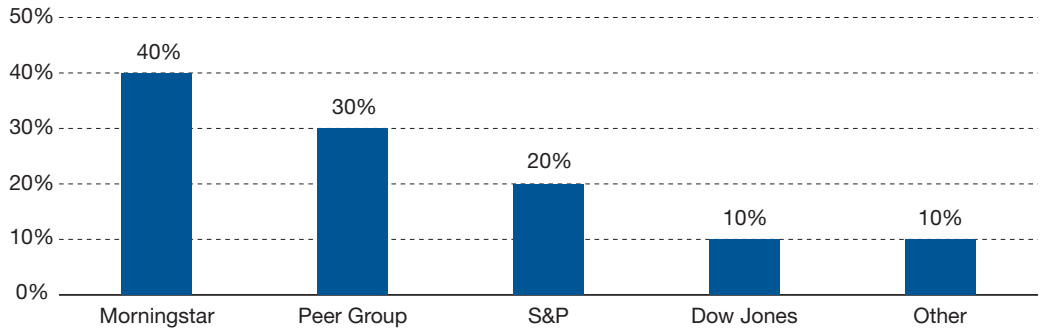


Percentages based on those who made changes. Figures do not sum to 100% due to multiple responses allowed.

Benchmarking

Target date fund managers use a variety of third-party benchmarks. Morningstar ranked as the number one (40%) outside benchmarking service, followed by peer groups, which were used by 30% of managers in 2011.

Exhibit 15 Third-Party Target Date Benchmarks Used



Figures do not sum to 100% due to multiple responses allowed.

Annuities and Future Changes

Interestingly, despite much fanfare around retirement income solutions, such as in-plan annuities, no target date fund managers had incorporated such solutions into their target date funds when we conducted the survey, and only 16% were considering annuity-type solutions for the future. This suggests target date managers recognize that acceptance of annuities in target date funds is still lacking.

Nearly half (46.2%) of the managers anticipate other changes to their target date funds within the next year. Change to the underlying funds was most commonly cited (33.3%), followed by examining the glidepath (25.0%).

Conclusion

Target date funds continue to evolve as managers routinely evaluate their glidepaths and the use of underlying funds. Notable differences between managers persist with regard to glidepath design, equity roll down, use of underlying funds and respective performance. Managers are revisiting their glidepaths more frequently and we note an uptick in the portion of managers applying a tactical overlay to their long-term strategy. Many have recently made modest changes to their glidepaths that generally did not involve dramatic shifts in asset allocation. The most notable changes over the last several years have been the added focus on inflation and ways to address this ongoing concern, alongside increased diversification within asset classes to reduce volatility. Underlying fund changes were also prevalent across managers. We anticipate this trend will continue in the future. Finally, managers continue to embrace proprietary benchmarks that change commensurate with their glidepath. However, this may change with the eventual passage of the Department of Labor's proposed target date fund disclosure regulation. The regulation requires a third-party benchmark to be used in communicating with plan participants about target date fund performance.

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