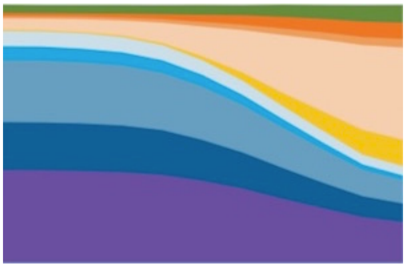
In Target-Date Space, It's Vanguard, Et Alia

By Kerry Pechter *Thu, Apr 27, 2017*

Vanguard's domination of TDF flows in recent years has paralleled its domination of overall mutual funds flows. Competitors search for ways to be different, but not too different.



Consecrated by the 2006 Pension Protection Act as a "qualified default investment" that defined contribution plan sponsors could safely auto-enroll their new participants into, target-date funds (TDFs) subsequently flourished in the DC investment space like an invasive weed.

TDFs now account for about a quarter of DC assets. In fact, they are perhaps the most viable investment in the DC space, which has steadily lost overall assets to rollover IRAs. Dozens of asset managers that distribute through DC plans want to expand their sales in the TDF business, though only about 10% of this business can be considered up for grabs.

Based on Morningstar's recent **snapshot** of the TDF market at the end of 2016, the field consists of a peloton of Vanguard, Fidelity, T. Rowe Price, American Funds, JPMorgan, TIAA and about 35 others. In starker terms, it's Vanguard and everybody else.

Vanguard's domination of TDF flows in recent years has paralleled its domination of overall mutual funds flows. Its net TDF flows for the year were $37 billion, raising its TDF asset level to more than $280 billion, or 8.2% of its total $3.4 trillion in mutual fund assets under management. In net flows, its nearest competitor was American Funds, with its actively managed lineup, which added $15.8 billion in TDF flows in 2016.

Of the top ten TDF providers, five had negative flows. Fidelity, the second-ranked provider, saw its TDF assets dip by about $2.8 billion, to $193 billion. Principal's fell by $497 million, John Hancock's by $239 million, and Wells Fargo Funds, whose parent has been mired in scandal, lost $6.6 billion in TDF assets.

The combined value of target-date mutual funds is now $880 billion, according to a recent Morningstar report, up from less than $200 billion in 2008. If you count the value of target-date collective investment trusts (CITs), as benefits consultant Mercer does, the total value of TDF rises to $1.29 trillion.

'You have to grow here'

As concentrated as the TDF business has become—the top 10 providers control more than 90% of the assets—the category is too huge and its flows too reliable (thanks to its unique status as the most popular default investment for auto-enrolled participants) for institutional fund providers to ignore.

"The target date fund area has a strong cash flow and overall growth," said Neil Lloyd, author of Mercer's new TDF study. "The DC market in general has had negative cash flow overall. So if you're going to grow in the DC space, you have to grow here."

For firms that want to grow their share of the TDF market, the challenge is to be the same as the leaders (in terms of offering a TDF option based on low-cost index funds or exchange traded funds) while trying to differentiate your offering with a different glidepath or asset allocation or transition-to-income option.

"At this stage, you have to do something different to catch anyone's attention," said Jeff Holt, associate director of Morningstar Manager Research. "You can't just copycat someone else. It's hard going but there's a reluctance to give up on it and a lot of incentive to try to figure out something that will make it work."

American Funds has succeeded in creating its own niche in the TDF area, even though its TDF is based on actively managed funds, not the trendier index funds. In March, American Fund TDFs were listed as top performers in several Lipper performance categories. The funds emphasize a shift to income-oriented equities over time, rather than simply reducing equity exposure. Its TDF assets grew by 27% in 2015 and 45% in 2016.

DFA differentiates itself by gradually moving investors to a safe 80% TIPS portfolio at the point of retirement. It entered the market in November 2015 and now has $323.5 million under management, according to Morningstar, for a growth rate of 1500% in 2016. Another fast grower last year was State Street Global Advisors, which grew 425% to $1.26 billion.

Even as the competition demands that TDF providers innovate more and devote more resources to their product—no TDF is really a passive investment, since the glidepaths require careful design—they face relentless downward pressure on fees. Eight years ago, the average TDF fee was 103 basis points.

Today, it's 71 basis points, according to Morningstar, ranging from as little as 13 basis points to as much as 119 basis points. On a market-weighted basis, the median fee is only 51 basis points, because Vanguard, at 13 basis points, accounts for such a large market share. If you include TDFs that are CITs, the median actively managed TDF costs 45 to 60 basis points per year and the median passive TDF costs 10 basis points, according to Mercer.

Passively managed TDFs are of course cheaper than actively managed ones. They appeal to plan sponsors because of their ease-of-evaluation as well as their low cost. "The passive solutions have greater simplicity," Mercer's Lloyd told RIJ. "There's less need for oversight. Investment committees don't have to debate the fund management strategy."

Well-publicized class action lawsuits charging plan sponsors with violating their fiduciary obligations to participants by offering funds with "excessive" fees have also driven employers toward indexed TDFs.

"Generally the lawsuits and fear of litigation have caused investors to gravitate to lower cost, and that's naturally index funds," said Morningstar's Holt. "It's not that everyone wants passive funds. The attention to fees take precedence over that."

Retention issues

TDF providers have also tried differentiating themselves by offering customized lineups, while others have tried TDFs that include guaranteed lifetime income option. PIMCO, for instance, became a thought-leader in custom space when its DC practice leader, Stacy Schaus, published "Designing Successful Target-Date Strategies for Defined Contribution Plans" (Wiley, 2010), about the advantages of custom TDFs.

But custom TDFs have never taken off, partly because there's already enough variety in terms of different glidepaths and asset allocations, Holt told *RIJ*. PIMCO, which has also seen a flight from its actively managed bond funds in recent years, has only $393.6 million in TDF assets, down 31% in 2016.

Prudential Retirement and Great-West differentiated themselves in the TDF space a few years ago when they introduced guaranteed lifetime withdrawal benefit riders on their TDFs. Prudential called its rider IncomeFlex and Great-West used the name Secure Foundation.

At the end of 2014, Prudential introduced Day One Target Date Funds, as CITs. At the end of 2016, Prudential followed up with Day One Mutual Funds, a series of target date mutual funds. In addition, there's a separate Day One IncomeFlex Target Date series. Great-West told *RIJ* this week that it has $8.0 billion in target date assets ($6.9 billion in target date funds; $1.1 billion in target date trusts). Of that amount, $567 million is in accounts with the SecureFoundation rider.

TDF providers arguably need to explore income-generating solutions to slow the out-migration of assets at retirement. As Mercer's report points out, retirees tend to liquidate their TDFs when they retire and roll over their savings to an IRA.

"Vintage year funds that had passed their target years experienced a decrease in total AUM," the Mercer report said. "This is not a significant surprise, and although a variety of reasons can be proposed, we are confident the key reason is individuals rolling their assets out of their DC plans at or around retirement."