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Target Date Maturity Funds *Aiming for Retirement Security*

This *Measuring Up* discusses the benefits and limitations of Target Date Maturity Funds, which emerged with the development of defined contribution plans.

Unlike defined benefit plans, defined contribution plans shift the risk and potential reward of a plan from the sponsor to the participant. Defined contribution plans have replaced defined benefit plans as the predominant source of retirement income for U.S. workers. Recent data suggest that about 17% of private workers participate in a defined benefit plan, while 56% participate in defined contribution plans.¹ This shift has increased the need for methods to enable plan participants to allocate funds effectively. Target Date Maturity Funds have emerged to meet this need.

Background

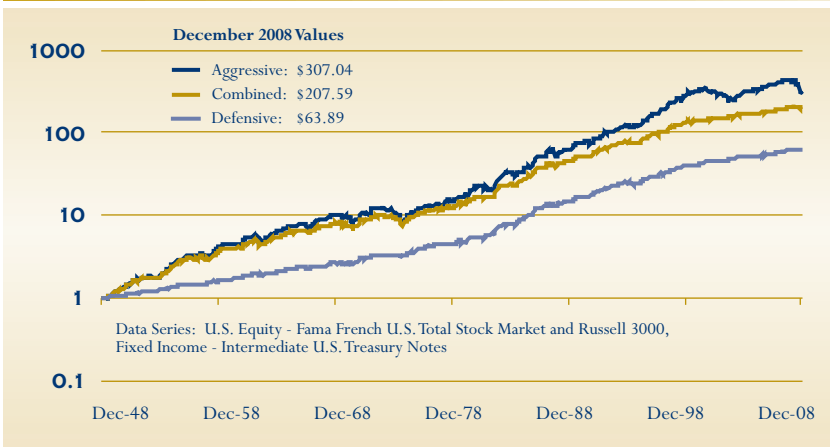
Defined contribution plan participants face a challenge. They seek capital growth to ensure an adequate pool of savings for retirement. Participants also seek stability of capital in retirement to avoid the risk of selling assets at depressed prices during a market downturn. Investment strategies with high equity allocations have achieved significant growth in capital; however, the growth has come with a price – high volatility. Fixed income-oriented strategies have generated stable returns but only limited capital growth. How does an investor reconcile these conflicting objectives? A solution would be a blend of both types of strategies. Many

industry experts contend that most plan participants lack the investment expertise needed to build a portfolio that balances return and risk requirements, using the traditional model of narrowly focused equity and fixed-income funds. Plan participants frequently make the major mistake of assuming additional risks following market upswings and becoming more defensive following market declines. The industry has responded to this challenge by designing a solution.

A Target Date Maturity Fund acts as a “bundled solution” to address a plan participant’s needs over the individual’s lifetime. Target Date Maturity Funds are structured for a specific retirement date. For example, a 2020 Target Date Maturity Fund assumes that a participant will retire in 2020 and will live for another 20 years or longer. A Target Date Maturity Fund seeks two objectives: (1) to accumulate a sufficient asset base on the target retirement date, and (2) to protect this capital as the retiree draws on this pool throughout his or her lifetime. Target Date Maturity Funds maintain a high equity allocation in early years to achieve growth and then reduce the equity commitment in favor of fixed income to protect capital later in the participant’s life.

¹ Salisbury, Dallas, “Boomer Bust? Securing Retirement in a Volatile Economy,” Written Statement for the United States Senate Special Committee on Aging Hearing on February 25, 2009, 2.

FIGURE ONE
Investment Results of Balanced Strategies (Growth of \$1.00)
December 1948 – December 2008



Target Date Maturity Funds have become a key force in defined contribution plans. Legislation has supported their growth. The Pension Protection Act of 2006 implemented an “automatic-enrollment” feature in defined contribution plans, and sanctioned Target Date Maturity Funds as a Qualified Default Investment Alternative (QDIA). This feature was initiated due to concern that a large number of workers were not choosing to participate in voluntary defined contribution plans. Automatic enrollment has increased the assets in Target Date Maturity Funds significantly. A recent study shows automatic enrollees were significantly

more likely to have their assets invested in Target Date Maturity Funds than traditional funds, and approximately 80% of these automatic enrollees invested exclusively in Target Date Maturity Funds.²

Management of Funds

We have explained the concept of a Target Date Maturity Fund. Will this concept work in practice? We have tested the concept using historical data. *Figure One* illustrates this principle.

Figure One shows a typical plan participant’s investment timeline, which we estimate at 60 years. This timeline includes a representative person’s working life, from approximately age 25 to 65 (40 years) and a person’s retirement from age 65 to 85 (20 years). The chart presents three different investment strategies. These options include aggressive, defensive and combined approaches. The aggressive option statically allocates 80% to equities and 20% to fixed income. The defensive option statically allocates 20% to equity and 80% to fixed income. The third option tries to reconcile the pursuit of growth with the need for capital stability in a dynamic manner over the participant’s investment horizon. It mimics a Target Date Maturity Fund. It begins with an aggressive stance, holding 80% in equities for the first 10 years (ages 26-35), and then making a

FIGURE TWO
Allocations and Returns of Target Date Maturity Funds as of December 2008

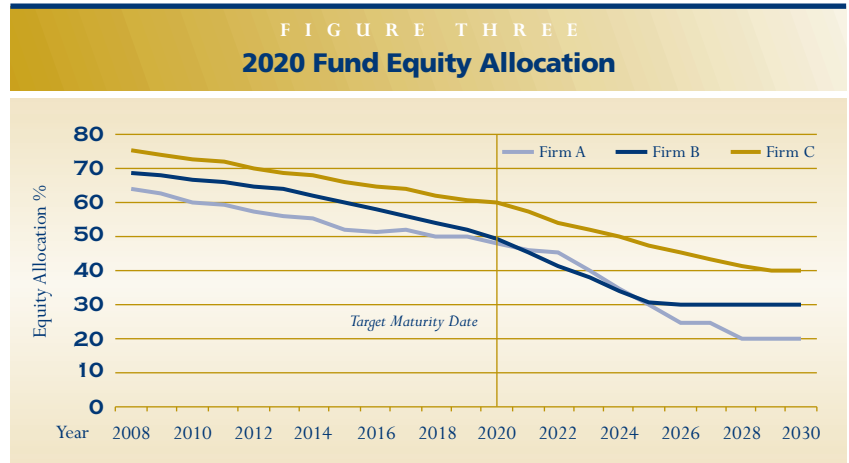
	ASSET ALLOCATION				RETURNS	
	Domestic Equity	Intl. Equity	Fixed Income	Cash	1 Year	3 Year
FIRM A (2005)	37.0%	8.3%	40.4%	14.3%	-24.5%	-4.0%
FIRM B (2005)	39.4%	10.2%	47.8%	2.6%	-22.2%	-2.6%
FIRM C (2005)	31.5%	7.7%	58.1%	2.7%	-15.8%	-0.5%
FIRM A (2025)	53.4%	13.4%	33.1%	0.1%	-33.7%	-6.9%
FIRM B (2025)	61.3%	19.8%	16.0%	2.9%	-35.9%	-7.6%
FIRM C (2025)	61.5%	15.4%	23.1%	0.0%	-30.1%	-5.2%
FIRM A (2045)	66.5%	17.2%	16.2%	0.1%	-38.9%	-8.8%
FIRM B (2045)	67.0%	22.3%	7.7%	3.0%	-38.8%	-8.8%
FIRM C (2045)	72.3%	17.7%	10.0%	0.0%	-34.6%	-6.6%

² Salisbury, Dallas, “Boomer Bust? Securing Retirement in a Volatile Economy,” Written Statement for the United States Senate Special Committee on Aging Hearing on February 25, 2009, 10.

gradual shift year by year, from 80% equity down to 20% equity over the next 40 years (ages 36-75). The allocation remains at 20% equity for the remaining 10 years of the investment horizon (ages 76-85). We tested these strategies using the most recent 60 years of capital market data from 1948 to 2008. As shown in the chart, the aggressive approach achieved the highest growth of capital. This approach also proved to be the most volatile, exhibiting large swings in value over time. The defensive approach achieved capital stability, but only limited growth. The combined approach proved to be the most efficient option, achieving meaningful capital growth with a high level of stability. The historical data appear to validate the basic concept of a Target Date Maturity Fund, i.e., to achieve significant capital growth during a participant's early years and protecting that capital during retirement.

Although Target Date Maturity Funds offer significant advantages, they also present challenges. These Funds therefore require evaluation and monitoring. While different Target Date Maturity Fund providers offer Funds with the same target retirement date, these Funds typically have different allocations, and therefore different returns. It is important for a participant to understand the current and the future allocation (glide path) of his or her Target Date Maturity Fund. *Figure Two* illustrates this principle. *Figure Two* shows the asset allocations and returns of Target Date Maturity Funds offered by three different providers. Although each firm offers a line of products with similar retirement dates, each also takes a different approach to asset allocation. *Figure Two* shows some meaningful differences in the December 2008 asset allocations among the providers for similar target dates. The Funds' unique asset allocations contribute to differences in returns.

Figure Three shows the different equity paths of 2020 Funds for three Target Date Maturity Fund providers. These Funds are likely to experience



different risk/return patterns over time due to the different asset allocation strategies, despite having a common target retirement date. We tested, on a forward-looking basis, the potential differences in risk/return patterns among these 2020 Funds. We projected Fund balances as of 2018 and 2028 for an assumed 55-year-old plan participant who will retire at age 65 in 2019. The beginning balance in 2009 is \$100,000. We assume the participant will make annual contributions for the next 10 years (ages 55-64), starting at \$5,000 and growing by an assumed 2.5% annual inflation rate. At age 65, the participant will begin to withdraw funds during the first retirement year in 2019 at a rate of \$40,000, which will grow at a 2.5% annual rate. *Figure Four* displays three potential outcomes for each glide path: favorable case, expected case and unfavorable case. The favorable case means that only 5% of the outcomes are likely to be better. The expected case means that half of the results are likely to be more favorable, while half are expected to be less favorable. The unfavorable case means that only 5% of the outcomes are likely to be worse. We also calculated the probability of depleting capital by 2028.

The three different glide paths lead to moderate differences in the Fund balance prior to retirement in year 2018. Expected values range from \$295,000 with Firm A to \$306,000 with Firm C. The differences in expected Fund values as of 2028, 10 years into retirement, become more pronounced.



310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302



FIGURE FOUR
2020 Target Date Fund Balances (\$000)

	2018 (AGE 64)			2028 (AGE 74)		
	Firm A	Firm B	Firm C	Firm A	Firm B	Firm C
FAVORABLE	422	449	471	265	320	416
EXPECTED	295	302	306	(48)	(30)	(21)
UNFAVORABLE	200	197	192	(254)	(263)	(274)
PROBABILITY OF DEPLETING FUND	0%	0%	0%	62%	56%	53%

The Funds from all three firms subjected the participant to the likely depletion of capital with probabilities ranging from 62% for Firm A to 53% for Firm C. Firm C offers much better upside potential than Firm A and B. This analysis demonstrates that different funds with the same target maturity date can produce meaningful differences in long-term performance and risk.

It is beneficial to evaluate the potential benefits and risks inherent in a Fund’s glide path in the monitoring and oversight of plan investments. A participant’s fund balance, contribution rate and withdrawal rate influence which glide path might be optimal for the participant. A plan sponsor should be aware of such factors in the selection of a provider.

Conclusion

A Target Date Maturity Fund can serve as an effective tool for retirement planning, enabling capital growth during a participant’s early years and stability during retirement. But these Funds also contain risks. A plan sponsor can fulfill its fiduciary obligations and strengthen the retirement security of employees by selecting a defined contribution provider that meets the needs of its plan’s participants. Yanni Partners, a Division of GBS Investment Consulting, LLC, is prepared to help plan sponsors evaluate the unique benefits and risks inherent in Target Date Maturity Funds as part of an overall evaluation of a plan provider.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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