**TOTAL TARGET DATE FUND** (TDF) provider assets increased from $1.3 trillion in Q4 2016 to $1.7 trillion in Q4 2017.

**LARGEST PROVIDER** now has a 36% market share and almost 2.5 times its nearest competitor.

**WHILE AUM GROWTH IS STRONG,** there’s continued evidence that assets still roll out of TDFs around retirement, and some evidence this could be happening earlier than retirement.

**IN GENERAL, TDFs** still have a strong home (US) equity bias.

**FEE COMPRESSION CONTINUES,** but focusing on fees alone may not be in participants’ best interests. The difference in performance of TDFs is more significant than the difference in fees.

**GIVEN THESE DIFFERENCES,** Plan Sponsors should ensure they are continually reviewing their TDFs.
TARGET DATE FUNDS: HIGHLIGHTS AND TRENDS

PASSIVE TARGET DATE FUNDS CONTINUE TO BE IN FAVOR

In comparison to the 2016 Target Date Survey trends data, by the end of 2017 we saw a small decrease in strategies, covered from 70 strategies to 68 as one fund was liquidated, and two funds now report to Mercer as a single fund.

Total Target Date Fund (TDF) assets continued to trend upward, reaching $1.7 trillion in 4Q17. This shows a positive three year growth in assets up from $1.3 trillion in 4Q16, and up from $1.1 trillion in 4Q15. The asset growth has been supported by strong participant directed cash inflows, with TDFs being the default investment option (QDIA) in many DC plans, and also by strong equity markets both domestically and globally.

Passive TDFs continued to gather interest among investors — with the market share of passively managed TDFs increasing to 51.8% in 4Q17. This is up from 48.9% in 4Q16 and 47.8% in 4Q15. In contrast, the market share of actively managed TDFs continued its decline to 36.8% of market share in 4Q17.

Despite the plan sponsor investment unbundling trend, the majority of TDF providers continue to construct their TDF portfolios using proprietary funds as the underlying investments (i.e. using a closed architecture approach). In fact, over 2017, the percentage of assets invested in closed architecture solutions marginally increased from 92.1% to 92.3%.

1. AUM for “providers” includes all TDF products managed by each provider that were included in Mercer’s survey. Some of the historical numbers were restated due to managers correcting some previous disclosures.
The largest four providers continue to dominate the TDF industry in terms of AUM, though their total market share has slightly declined over the past five years. In recent years, we have seen stabilization of the largest four providers constituting around 75% of the market.

The separation in growth of assets amongst the four largest providers is seen below:

The largest provider now has a market share of over 36% and is approaching 2.5 times the size of its nearest competitor.
VINTAGE YEAR TRENDS

The chart below highlights the strong growth in assets under management in TDFs; however, as was noted last year, the increase was not experienced equally across vintage years.

- While performance played a role in the asset growth, clearly cash flow is a big factor. In the chart, strong growth was shown in vintage years 2060–2020. In the “retirement years” 2015–Income, the aggregate assets under management did grow marginally, but the rate of growth was far lower.
- In addition, an interesting aspect is how the assets peak in the 2030 vintage year and then decline in the 2025 and 2020 vintages. This is much more pronounced than shown in the 2016 study.

The drop off of assets in the retirement years was not a particular surprise given we know that many participants still transfer assets out of the plan at or after retirement. In addition, TDFs only really became the dominant default fund choice after the passing of the Pension Protection Act in 2006, i.e. many older participants were not defaulted into TDFs. The decline in 2025 and 2020 vintages is something to continue to monitor; it could be a sign that older participants are moving out of TDFs prior to retirement. Previous studies have suggested this may be the case.

A COMPARISON OF AUM BY VINTAGE YEAR FOR 4Q17 AND 4Q16

2. “Change” is the combination of performance and cash flow.
Overall, the allocation to growth assets is largely unchanged ignoring the natural reduction expected from the progression of the glide path. This year, we calculated an asset-weighted average glide path where we weighted the glide path allocations by the assets in each portfolio. (A challenge with the median is it equally weights the largest and the smallest provider.) In this way, we can see whether there was any bias towards investing in either a fund with lower or higher growth asset allocations. In the chart, you can see that the asset-weighted average glide path and the median glide paths are very similar, so there does not seem to be a bias in the glide paths of the funds with greater market share.

As seen in 2016, some of the managers in 2017 with the ability to implement tactical views have reduced allocations to growth assets within shorter-dated vintage years.
Over the past five years, we have seen two key changes to the international equity allocations:

- In general, an increasing allocation to international equities.
- Typically, a higher international equity allocation in longer dated vintages (i.e. those used by younger participants).

The past year has seen the international equity allocations remain fairly static. However, the asset-weighted average international equity allocation is higher than the median across the board. Maybe a higher international equity allocation helps to attract TDF assets?

What is probably most interesting is how the international equity allocations are typically well below the international equity component of the All-Countries World Index (ACWI) (47.8%). (Although a couple of providers do align with ACWI, they are the exceptions.) In our discussions with TDF managers, many have noted they have not aligned with the ACWI, and have continued with portfolios that display home equity bias for the following reasons:

- American participants have a natural home equity bias — partially due to a greater familiarity with US equities, but also given that their commitments are US-based.
- Most of the TDF peers similarly display home equity bias (our survey confirms this).
- There is some evidence that US equities have displayed less downside risk in times of stress than international equities.
We have continued to highlight that although TDFs may be “set it and forget it” for participants, this should not be the case for plan sponsors. The difference in returns between TDFs can be significant, and 2017 was no exception.

These differences in returns can make a real difference in participant outcomes.

The following charts illustrate the return distribution of TDFs by vintage year over 2017 and the five years to 2017.

The key here is that with the 2030 fund, the accumulation over five years for the median manager would have amounted to $1,579, at the 95th percentile, the accumulation would have been $1,699 and at the 5th percentile, the amount would have been $1,367. Doing the same calculation for the 2050 fund gives a difference of $320, and for the Income fund (a smaller) difference of $178. As you can see, TDFs returns can vary quite significantly, and these can have a meaningful impact on participant outcomes.
It is key to remember that past performance is not always a good predictor of future performance, and it is future performance that matters. If a TDF consistently underperforms its peers, it may not be a reason to change providers, but it is important to understand why the underperformance may have taken place. The reasons could include:

• Glide path and roll down structure.
• Differing strategic asset allocation or asset diversification.
• Use of dynamic or tactical asset allocation.
• Amount of exposure within underlying funds to active or passive management.
• Underlying manager alpha (or negative alpha).

As evidenced from the asset growth trends discussed earlier, there has been a move towards passive funds potentially fueled by the desires of plan sponsors to reduce fees. The shift toward passive has also led to downward pressure on fees for active funds — with many providers reducing fees over the last few years. In general, all categories of TDF (active, passive and hybrid) recorded a decrease in median fees across vintage years. As of 4Q17, median fees across vintage years for actively managed TDFs ranged from approximately 0.46% to 0.60% versus approximately 0.10% to 0.13% for passive funds. Larger TDF providers appear to have benefited from their larger asset base, allowing them to charge lower fees relative to smaller providers. This increased success for larger providers may also be due to the prevalence of fiduciary litigation that has occurred specific to plan fees.

Between 4Q15, 4Q16 and 4Q17, the median fee for passive TDFs decreased by one basis point, which is significant relative to the already low fees for this space. Active fees reduced by approximately three basis points. This fee reduction may be attributable to the launch of several low-cost products disrupting the passive TDF space and the necessity for providers to remain fiscally competitive.

Despite the strong focus on fees, we believe the analysis earlier highlights that the differences in performance of TDFs are far more significant than the differences in fees.
The significant growth of TDFs and their sheer dominance has been amazing, and we certainly believe that most participants who were unsure of how to invest have benefited from this development.

CONCLUSION

The fact that so many participants simply default into TDFs does increase the importance of the plan sponsor’s selection of the TDF provider. In February 2013, the DOL was acutely aware of this and issued a series of tips for fiduciaries to assist in the selection and evaluation of TDFs, emphasizing the gathering of information needed to determine whether a fund is prudent and documenting the process. Given the differences we are seeing in performance, and the potential impact on participant outcomes, it is appropriate to remind Plan Sponsors that the DOL expects them to:

1. Establish a process for comparing and selecting TDFs.
2. Establish a process for the periodic review of selected TDFs.
3. Understand the fund’s investments and how these will change over time.
4. Review the fund’s fees and investment expenses.
5. Inquire whether a custom or non-proprietary TDF is a better fit for the plan.
6. Develop effective employee communications.
7. Take advantage of available information to evaluate the TDF program.
8. Document the selection and review process.

Given the differences in performance, and potential impact on participant outcomes, it’s a good idea to review the DOL guidance on TDFs.

LOOKING AHEAD

Finally, it will be interesting to watch future developments or threats to the dominance of TDFs. The one limitation of TDFs is they do not take into account individual circumstances. We are beginning to see alternative solutions coming to market that tailor asset allocations to individuals, and through the advent of technology can do so without needing participant engagement. Some of these products are in their early development, but it is worth watching this space.

3 https://www.dol.gov/agencies/ebsa/key-topics/retirement/401k-plans
MERGER IS HERE TO HELP

This survey supports our consulting in the TDF space. In addition to the survey content, we perform detailed research reviews covering over 96.8% of the assets surveyed. For more information on Mercer’s TDF Survey and related content, please visit: Mercer.com

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