

# Overview of Index Choices

## Types



- **Standards** to be Achieved. The way things should be.



- **“Lifetime Models”** integrating human & investment capital from cradle to grave



- **Barometers** of current practices, using peers. Group think, or the way things are.



- **Hybrids:** It's unclear what these indexes are?

## Contrasts of Objectives and Theories

	Objective	Theory
	Safety & Growth with equal priority	None
	Common practices – peer average	Consensus: Group Think
	Constant risk of total capital (human + investment) throughout life	Individuals want/need constant risk throughout life
	(1) Safety first – top priority (2) Growth with risk control	Efficient Frontier, Capital Market Line, Liability-Driven Investing, Loss Theory, Separation Theorem

# Choosing a Target Date Fund Index

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May, 2009

Unlike the dozens of U.S. stock indexes, there are only four target date fund indexes. Dow Jones introduced their indexes first, in April 2005. Then our firm, Target Date Analytics (TDA), introduced its indexes in October 2007. Plan Sponsor magazine adopted the TDA indexes in August of 2008 and re-branded them as the PLANSPONSOR On Target Indexes (OTI). Then Standard & Poor's launched their indexes in late 2008 followed in early 2009 by Morningstar with their Lifetime Allocation Indexes.

These four indexes differ substantially in composition and philosophy. Let's discuss philosophy first:

- The S&P indexes are industry averages, reflecting common practices among current target date fund offerings. S&P describes this construction as follows:  
*"Each index is representative of the investment opportunity available to investors for the corresponding target date horizon, with asset class exposures driven by a survey of available target date funds for that horizon."*
- The Dow indexes have a stated objective to: *"measure the performance of a lifecycle portfolio that seeks to grow and preserve real value over time."*
- Morningstar Lifetime Allocation Indexes are *"a complete family of asset allocation indexes with varying risk levels to help investors and fiduciaries evaluate these funds to find the best fit."* These indexes were released 18 months after the OTI indexes and mimic the OTI risk families of Conservative, Moderate and Aggressive. In the following we focus on the Conservative series for comparability to the OTI signature Defensive series. The Morningstar indexes integrate assumptions about human and investment capital, with a model for maintaining constant risk throughout life. There is no stated reason for investors to desire constant risk throughout life.
- The PLANSPONSOR On Target Indexes have two objectives: *"(1) Protect the purchasing power of contributions with a very high probability, and (2) Grow assets with a reasonably high probability, without jeopardizing the primary protection objective."*

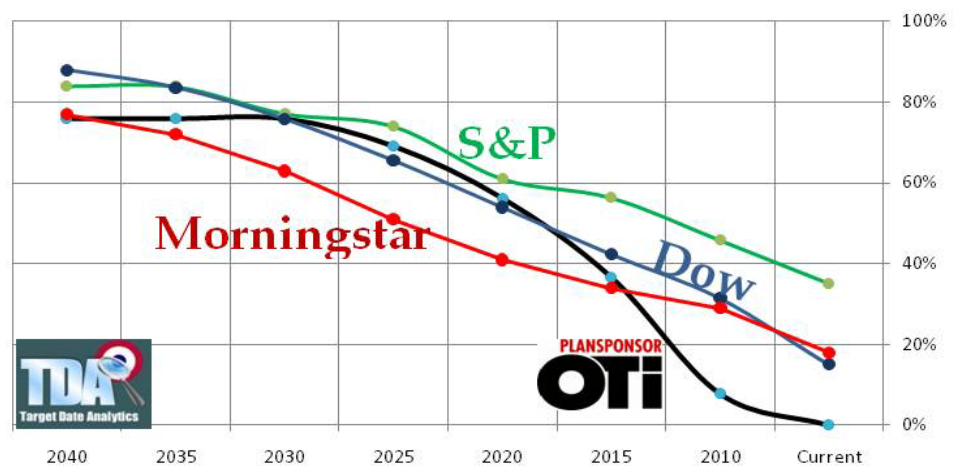
The major difference between the Dow and OTI objectives is priority. Dow places equal emphasis on preservation and growth whereas OTI emphasizes preservation over growth. **In summary, the OTI indexes are standards – the way target date funds should be managed. The S&P indexes are common practice aggregates. The Morningstar indexes are cradle-to-grave benchmarks that assume total capital (human plus investment) can be approximated, and that it is desirable to**

[maintain constant risk throughout life. And the Dow Indexes are some sort of hybrid.](#)

Unfortunately, we find common practice S&P indexes woefully lagging the OTI standards, as well as the Morningstar and Dow indexes. Target date funds are a great idea with awful execution, at least so far.

These differences in philosophy and objectives lead to materially different index compositions and results. The following exhibit summarizes composition differences at the broad equity allocation level. As you can see, as the target date approaches the S&P indexes are the most aggressive, followed by the Dow and Morningstar, and then the PLANSponsor OTI are the most defensive. All 4 indexes except Morningstar are quite similar in equity allocation at the more distant dates. The Morningstar Conservative series is more defensive at more distant dates, and in line with Dow indexes as the target date nears. We believe that allocations near target date are critical to proper risk control, and that there is little need for conservatism in the long-dated funds.

## Glide Paths: Equity Allocations **PLANSponsor OTI** is the most conservative near target date

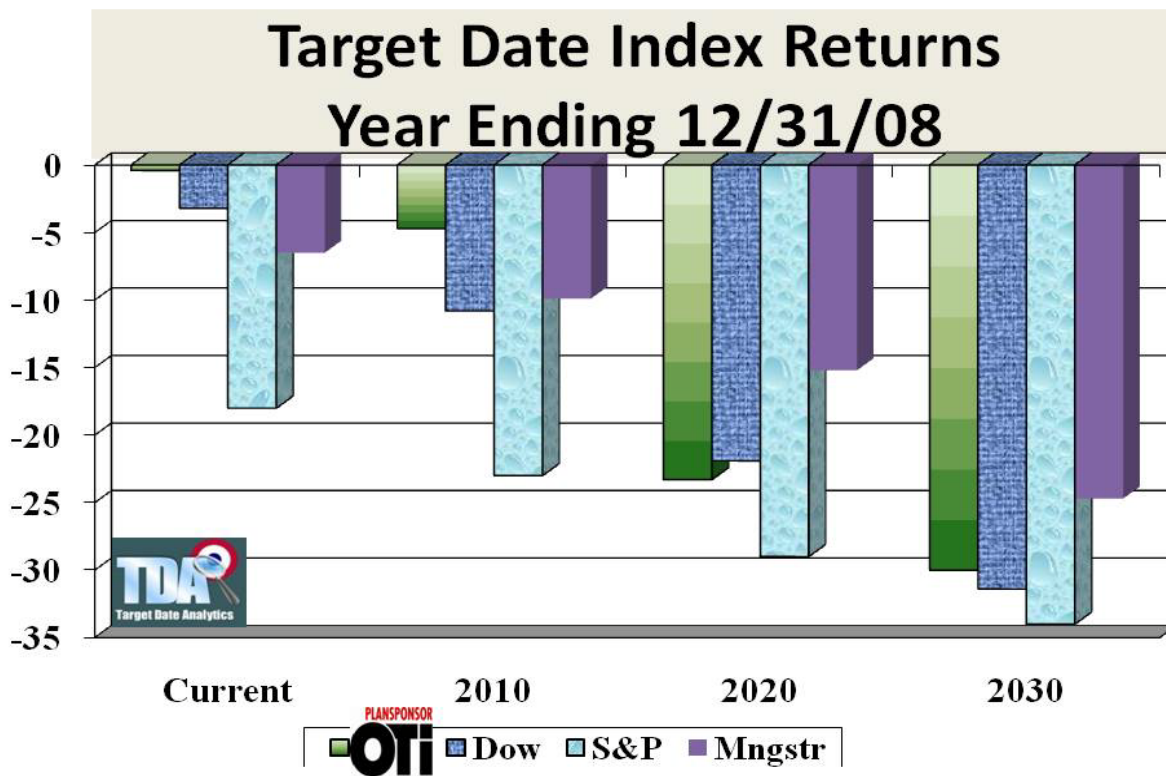


There is an ongoing debate raging in the target date industry regarding the purpose of target date funds. So far it's TDA versus the industry. We at TDA believe that target date funds should be limited to the accumulation phase of a participant's lifecycle, and that the distribution phase is best served by vehicles designed for this purpose, like annuities. [Vehicles designed to address longevity risk should be employed post-retirement because there is no glide path that can handle this life-long task.](#)

Accordingly, we believe that target date funds should be entirely in safe non-risky assets at target date, waiting for the participant to move to the next phase, which they should be thinking about long before retirement. But the industry doesn't see it our way. The target date fund industry sees target date funds continuing beyond the target date. Some see accumulation funds morphing into distribution funds at target date and continuing on, in some cases to death. This is akin to viewing the

target date as a small speed bump on the highway of life. Truth in advertising dictates that funds taking this extended view should be re-labeled so the investor knows their intended lifespan. For example, 2010 funds that are intended to serve the investor for 30 years beyond retirement date should be re-labeled “2010-to-2040 funds”, or “2040 target death funds.” But not all fund companies extend their glidepaths. Some fund companies roll their target date funds into “Income Funds”, which have the objective of throwing off reliable income while preserving principal, rather than managing longevity risk. Both approaches extend the investor’s participation beyond target date. What do you think the role of target date funds should be? Should they continue beyond target date?

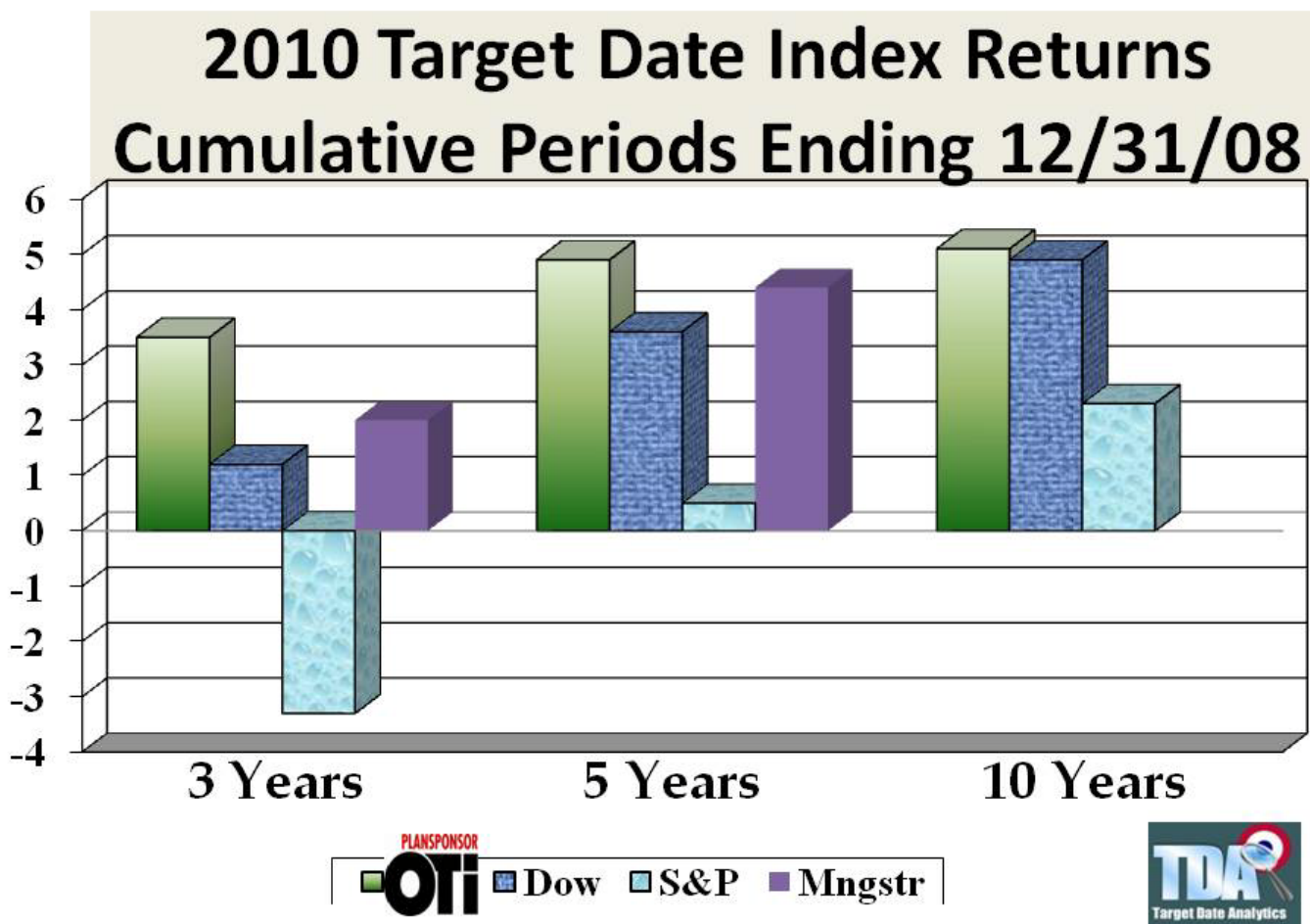
These composition and philosophical differences have significantly impacted target date index performance in 2008, as shown in the next exhibit. The recent meltdown has been a wake-up call for the target date industry and gives TDA an “I told you so” that we wish we didn’t have. Our greatest concern is for investors in near-dated funds, who are at or near retirement, and have the most at stake both emotionally and monetarily. For the most part these 60-plus year old investors are in target date funds as a default option in their 401(K) plans, since target date funds are one of three qualified default investment alternatives (QDIAs). Do you suppose any of these folks were prepared for the kind of disastrous loss that has occurred in the Morningstar, S&P and Dow indexes? Did they know the risks they were exposed to? That is, what is the better standard?



(S&P returns are approximate, and represented by TDA’s peer group indexes.)

Your choice of index makes a big difference in your evaluation of target date fund results. [Choose the index that is most in line with the plan participants' understanding of what target funds should be.](#)

But the OTI defensive posture at target date is not the only difference among the indexes. Diversification is also an important distinction. The S&P indexes are not very well diversified, comprising mostly U.S. stocks and bonds, because this is the current industry practice. The Dow and Morningstar indexes are somewhat more diversified, and the newer Dow real return indexes are even better. But the most diversified indexes are the OTI, representing the world market. The benefits of diversification are shown in the following long-term performances of 2010 funds.



(S&P returns are approximate, and represented by TDA's peer group indexes. Morningstar indexes go back only 5 years.)

As you can see, the choice of target date index makes a big difference over longer horizons, extending back beyond the current meltdown into better times. So now you can make an informed selection.

For more information on target date indexes, please visit the following:

Dow: <http://www.djindexes.com/targetdate/index.cfm?go=overview>

S&P:

[http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices\\_targetdate/2,3,6,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_targetdate/2,3,6,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0.html)

Morningstar

[http://corporate.morningstar.com/us/documents/Indexes/INS\\_INX\\_LifetimeAllocationFactsheet.pdf](http://corporate.morningstar.com/us/documents/Indexes/INS_INX_LifetimeAllocationFactsheet.pdf)

PLANSPONSOR On Target Indexes: [www.tdbench.com](http://www.tdbench.com)