AUTHORS

Erin Browne
Managing Director
Portfolio Manager

Bransby Whitton
Executive Vice President
Product Strategist

Georgi Popov
Senior Vice President
Product Strategist

Shawn Coffman
Product Strategist

What the Pandemic Taught Us About Target Date Funds

The ability to "set it and forget it" has long made target date funds (TDFs) an appealing investment for defined contribution (DC) participants. They can leave it to investment professionals to manage allocations and dial down risk as retirement nears. It's inherently a long-term strategy.

Yet 2020 highlighted another type of risk to TDF investors – the risk that severe volatility could prompt rash selling that crystallizes losses. Such was the case last March, when the spreading COVID-19 pandemic spooked markets. The 12% plunge on March 16 was the third-biggest percentage loss ever for the S&P 500 Index, eclipsed only by Black Monday in October 1987 and October 1929 near the start of the Great Depression.

This underscores why it is important for TDFs to be designed to instill confidence in participants. Here are our lessons from the pandemic and three ideas to help advisors and sponsors keep participants invested.

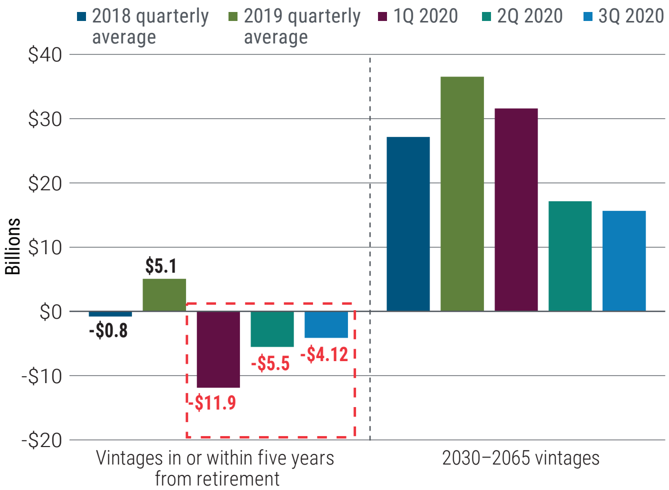
LESSONS FROM THE COVID-19 CRISIS

March 2020 reminded us that financial markets can do the seemingly impossible. Based on a normal distribution of returns, historical data suggests a single-day decline of 12% in the equity market should almost never happen – yet it did on 16 March. That's why factoring in these extremely rare events is imperative for defined contribution (DC) advisors and sponsors when selecting investment options, particularly as they relate to the qualified default investment alternative (QDIA) option – typically a TDF – for those nearest to, or in, retirement. Figure 1 illustrates why this is so critical for participants, especially those with the most to lose. In the first quarter of 2020 alone, net outflows from TDFs in retirement or within five years from retirement totaled $11.9 billion, almost 15 times greater than the 2018 quarterly average, and in sharp contrast to the net inflows seen in 2019. We saw a similar theme play out in 2008.

Importantly, as indicated by the continued outflows in the near-retirement vintages during the second quarter and the third quarter of 2020, some participants were slow to re-enter the market. They missed out on a remarkable recovery, effectively "crystallizing" their losses.

Figure 1: Individuals closest to retirement withdrew the most

TDF flows by target retirement year vintage

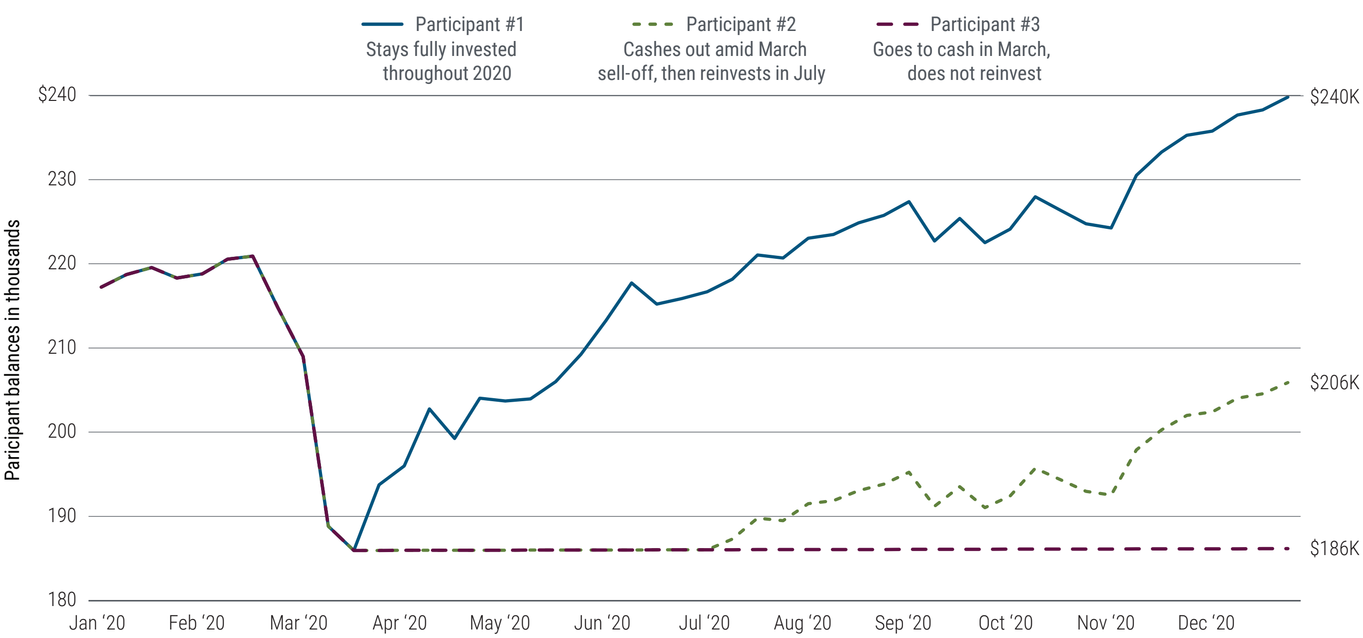


Source: Morningstar and PIMCO as of 30 September 2020

For participants about to retire, cashing out or trying to time the markets can have disastrous results. Figure 2 shows three hypothetical participants, all of whom had planned to retire at the end of 2020. While we do not know exactly how many near retirees ended the year with less than they started, we can assume the number is meaningful based on the accelerated withdrawals reported by Morningstar. As you can see, participant 1, who stayed invested, gained 11% during the period, whereas the other two participants – even the one who re-entered the market – retired with a loss during 2020.

Figure 2: Rash selling can be costly

Differing participant experiences in 2020



Source: Morningstar and PIMCO as of 31 December 2020

Hypothetical example for illustrative purposes only.

Performance is based on the median performance of the Morningstar U.S. Fund Target Date 2020 category; the uninvested rate of return employs the U.S. 1-month Libor rate. The average savings balance for a hypothetical 65-year-old participant is based on Vanguard's "How America Saves" 2020 publication.

KEEPING PARTICIPANTS INVESTED

While the markets cannot be controlled, advisors and sponsors can help guide participant behavior in times of uncertainty and volatility.

Here are three ideas to help keep participants invested amid challenging market environments:

1. Diversification remains the first line of defense

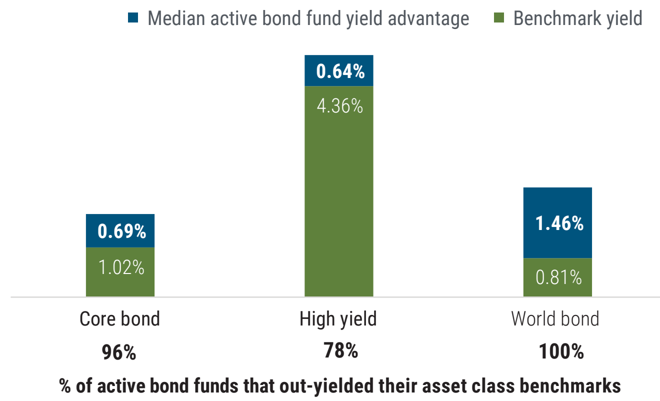
Dissecting the level and type of risks along the entire glide path is essential to understanding the degree to which a glide path is diversified. Early on, when equity allocations are highest, equity exposures are calibrated by market capitalization (e.g., small cap), geography (e.g., U.S., non-U.S. and emerging markets) and by the degree of equity-like substitutes (e.g., high yield bonds, real estate investment trusts, etc.). In our view, the glide path allocation among risk-seeking assets should be focused on maximizing returns per unit of risk. While this emphasis should persist throughout the glide path, it is most critical for younger participants who are most heavily invested in risk-seeking assets. The relative performance of TDFs during the 2020 drawdown showed that advisors and sponsors should pay special attention to so-called "through" glide paths for older age cohorts given the meaningfully higher equity allocations at retirement relative to "to" providers.

Turning to fixed income, the most common allocation in the majority of glide paths is core bonds, or Bloomberg Barclays US Aggregate Bond Index (Agg) exposure. While glide paths may use other fixed income allocations such as Treasury Inflation-Protected Securities (TIPS) and high yield bonds, these allocations are typically so small that the average glide path yield essentially equals that of the Agg at 1%.[1] Given that starting yields tend to be an accurate forecast of long-term expected returns, broadening fixed income diversification should not only help improve estimated risk-adjusted returns (Sharpe ratios), but also estimated returns, assuming such diversifiers can enhance the overall fixed income yield. For example, high yield currently offers roughly 3.3 percentage points of additional yield to core bonds (see Figure 3). We estimate well-diversified fixed income allocations in glide paths can enhance the yield of core bonds by anywhere from 0.5 to 1 percentage point in the current market environment. This added yield enhances estimated returns from fixed income and should further support improved participant outcomes. For more on our views, please see PIMCO's December 2020 *Asset Allocation Outlook*, "Early Cycle Investing: Navigating the Growth Rebound."

1 As of 31 December 2020

Figure 3: Active bond managers have out-yielded their passive peers

Median active bond fund's yield advantage over their benchmark



Source: Morningstar and PIMCO as of 31 December 2020

Represented benchmarks: Core Bonds - Bloomberg Barclays US Aggregate Index, High Yield - ICE BofAML High Yield BB-B Constrained Index, World Bond - Bloomberg Barclays Global Aggregate ex-US (USD-Hedged) Index. Core Bond includes Core-Plus Bond category.

2. Active management can help cushion volatility and enhance risk management

Over a typical 40-year accumulation phase, a 1 percentage point boost to annual returns from the fixed income portion of a glide path can raise a participant's balance at age 65 by $39,000 (a 7% improvement), resulting in seven additional years of expected retirement income.[2] Of course, active management is accompanied by higher fees so considering the value proposition is essential. Ultimately, advisors and sponsors want to optimize participants' fee dollars to active opportunities where enhanced returns are most likely to be achieved. We think a blend of active bonds and passive equities gives the best of both worlds, and this trend continues to gain momentum (see our *Featured Solution* from last year, "Blend Is the Trend").

2 Hypothetical example based on the industry average glide path, as provided by Morningstar as of 31 December 2019, which represents latest available from the source. Salary and contribution assumptions are based on Employee Benefit Research Institute (EBRI) data. Return assumptions based on PIMCO's supersecular capital market assumptions. Calculated real ending account balance at retirement is $538,000, as of 31 December 2020.

In response to the pandemic, yields across the globe have reached new lows. This creates a major headwind for income generation in DC plans. Fortunately, the track record of active managers out-yielding their respective benchmarks is strong and consistent. Figure 3 illustrates that for the top three bond categories in DC, roughly 90% of active bond managers meaningfully beat their benchmarks in yield[3] (represented by the blue portion of bars). Broadening the fixed income investment universe and employing active management may lead to a meaningful boost in income generation, and a greater number of participants achieving a successful retirement.

3. Strategic and tactical communication programs are essential to building participant confidence

While high quality and effective participant communications from sponsors are always needed, engagement is critical during uncertain and volatile periods. Here, we offer what we view as best practices for participant communications:

Goal	Suggestions
Address emotions	Reassure participants of the long-term nature of their investments and that volatility is an inevitable part of the journey. Help participants understand the risks of changing or liquidating positions during times of volatility. Locking in losses can adversely affect a participant's retirement plan. Of course, this is particularly true for older participants who are closer to, or in, retirement. Encourage rational decision-making.
Confirm objectives	Encourage participants to confirm that their investments match their objectives. Remind participants about the risk/reward nature of investing – and perhaps suggest they reach out to their plan administrator or financial advisor for guidance.
Reinforce investment attributes	If applicable, remind participants of additional layers of defense tied to their investments (i.e., in a TDF), such as explicit downside risk mitigation, which can help improve confidence and minimize behavioral mistakes.
Communicate often	Participants want guidance during uncertain periods. It's important to communicate often. Remind them of best practices for investors, such as staying invested when markets are volatile.
Remind them again	Participants often forget (or don't know) there are people and resources available to them.

Source: PIMCO

BUILDING RESILIENT TDFS

There is a lot to reflect on from the past year. At PIMCO, we challenge ourselves to learn from market events and build a resilient TDF solution, one that gives participants the confidence to stay invested by offering a smoother ride into retirement. We hope these lessons and ideas help further your conversations about retirement investing as well.

The authors thank Erik Henrikson for his contributions to this paper.

3 As of 31 December 2020

PIMCO

All investments contain risk and may lose value. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **High yield, lower-rated securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. **Diversification** does not ensure against loss.

Target Date Funds are designed to provide investors with a retirement solution tailored to the time when they expect to retire or plan to start withdrawing money (the "target date"). Target Date Funds will gradually shift their emphasis from more aggressive investments to more conservative ones based on their target dates. Target Date Funds invest in other funds and instruments based on a long-term asset allocation glide path developed by PIMCO, and performance is subject to underlying investment weightings, which will change over time. An investment in a Target Date Fund does not eliminate the need for an investor to determine whether a Fund is appropriate for his or her financial situation. An investment in a Fund is not guaranteed. Investors may experience losses, including losses near, at, or after the target date, and there is no guarantee that a Fund will provide adequate income at and through retirement.

Glide Path is the asset allocation within a Target Date Strategy (also known as a Lifecycle or Target Maturity strategy) that adjusts over time as the participant's age increases and their time horizon to retirement shortens. The basis of the Glide Path is to reduce the portfolio risk as the participant's time horizon decreases. Typically, younger participants with a longer time horizon to retirement have sufficient time to recover from market losses, their investment risk level is higher, and they are able to make larger contributions (depending on various factors such as salary, savings, account balance, etc.). Generally, older participants and eligible retirees have shorter time horizons to retirement and their investment risk level declines as preserving income wealth becomes more important.

Asset allocation is the process of distributing investments among various classes of investments (e.g., stocks and bonds). It does not guarantee future results, ensure a profit or protect against loss. The **Sharpe Ratio** measures the risk-adjusted performance. The risk-free rate is subtracted from the rate of return for a portfolio and the result is divided by the standard deviation of the portfolio returns.

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS

S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The Index focuses on the large-cap segment of the U.S. equities market. **Bloomberg Barclays Global Aggregate ex-USD** (USD Unhedged) Index provides a broad-based measure of the global investment-grade fixed income markets. The major components of this index are the Pan-European Aggregate and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds and Canadian Government securities. **Bloomberg Barclays U.S. Aggregate Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. **ICE BofAML U.S. High Yield, BB-B Rated, Constrained** Index tracks the performance of BB-B Rated U.S. Dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Qualifying bonds are capitalization-weighted provided the total allocation to an individual issuer (defined by Bloomberg tickers) does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face value of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. It is not possible to invest directly in an unmanaged index.

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This material contains the current opinions of the manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

70269

CMR2021-0210-1520589