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Passive Target-Date Funds Come at a High Price

Rich Weiss, Senior Vice President and Senior Portfolio Manager for Asset Allocation Strategies at American Century Investments®, argues that a narrow focus on target-date fees can compromise fiduciary decision-making.

P&I: When choosing a target-date fund, you believe that the active/passive decision is less about cost and more about fiduciary duty. Can you elaborate on that?

Rich Weiss: Department of Labor guidelines lay out a sponsor's main fiduciary responsibilities. First among them is an understanding of the glidepath design and construction, which is the main driver of returns in a target-date fund. Second is an understanding of risk. The third is reviewing fees and expenses. By focusing primarily on cost, which is what many sponsors do in selecting a passive target-date fund, they are letting fees and expenses essentially determine the process rather than considering all the responsibilities involved in a more complicated investment decision.

We believe it's a mistake for plan sponsors to think they are within the law's safe harbor provisions simply by choosing the low-cost provider. In a passive target-date fund, the lack of risk controls at the sub-asset class level can result in inferior risk-adjusted return and a wider variation of returns among participants and across time. Passive approaches also have significant deficiencies in terms of limiting diversification, which can produce a sub-optimal portfolio in terms of risk management. All of which can affect wealth accumulation over a participant's lifetime. What initially may appear to some to be the safe or prudent selection actually winds up being a sub-optimal choice from an investment perspective, and the most risky selection for participants and ultimately for the plan fiduciary.

P&I: The idea of a passive target-date fund is a little counterintuitive, because glidepath design is by definition an active decision. Where does passive enter into it?

Rich Weiss: All target-date funds include active decisions on key asset classes and geographies, which would be choosing equities rather than bonds, or domestic rather than international. Where passive target-date funds run into trouble is at the sub-asset class level.

At the sub-asset class level, passive target-date funds are allocated by market capitalization. This can lead to sub-optimal, if not perverse weightings in those sub-asset classes. For example, a passive target-date fund will specify the relative weight of U.S. and non-U.S. equities. But within non-U.S. equities, the relative weights of developed and emerging markets equities (EME) are governed completely by the market cap of those market segments on any given day.

This may come as a shock to many plan sponsors, but you actually could end up at age 70 with a higher allocation to emerging market equities relative to developed international equities than you had at age 30, if that's the way market-cap weights are trending in the global index. This is exactly the opposite of what's recommended for the participant's later life stages, where reducing equity risk is extremely important. As another hypothetical example, consider country allocations within emerging market equities. One day, you could have a 30% weight to China and then a year later have a 15% weight, not because the target-date fund manager thought China was a better or worse investment opportunity, but solely because China's market-cap weight in the index was rising and falling, and you were just adrift in that ocean with no one steering the ship. This could actually happen: Chinese equities rose more than 100% between November 2014 and June 2015, then crashed during June. The Shanghai benchmark index lost 20% of its value—about $3 trillion—in just a few weeks.

That's the kind of roller coaster that a target-date investor is riding with a passive market-cap allocated target-date fund. It's one thing to permit individual stock and bond investments to be determined by their relative market capitalizations, but it's quite another to apply that same hands-off, passive approach to asset allocation. There is no academic, theoretical, or real-world justification for avoiding such decision-making other than it being the cheaper option.

P&I: How does that rudderless ship example relate to the issue of fiduciary duty?

Rich Weiss: Asset allocation and glidepath design are the major sources of risk and return in a target-date strategy—more so than active management of any specific asset class—and it's alarming to us that passive target-date funds leave much of that process unmanaged. When free-floating market capitalization weights are allowed to determine the allocation of sub-asset classes, the most critical decisions in fund design are left to chance. Thus, passive target-date funds lack adequate risk controls across a range of decisions, including size (large-cap or small-cap equities), bond sectors (high-yield or high quality), bond duration and interest rate exposure, as well as equity styles, such as growth or value.

The manager is effectively abdicating what should be active, strategic decision-making. All of these relative allocations are allowed to float freely without any constraints or active oversight; they all vary day-to-day with market capitalization; none of them are actively managed. Passive target-date funds force you to sit back and permit the markets to make many of your most important asset allocation decisions for you. To us, that seems like a terrible way to optimize the key decisions that contribute most to favorable outcomes for participants.

P&I: You also argue that passive target-date funds offer inferior diversification opportunities. How does this relate to the fiduciary and allocation issues?

Rich Weiss: In the name of cost, passive target-date fund providers often limit diversification to those asset classes that can be indexed cheaply and effectively. But only a handful of asset classes can be indexed cheaply and effectively. Therefore, when target-date fund sleeves are limited to indexed asset classes, participants can end up missing significant opportunities in a host of inefficient asset classes, such as TIPS [Treasury Inflation Protected Securities], high-yield bonds, real estate securities, commodities, emerging-market bonds, equity long-short strategies, etc. These non-core asset classes and investing approaches can help diversify the target-date portfolio and potentially lower portfolio risk over the long term, as well as increase risk-adjusted return and the terminal wealth for the participant.

Therein lies the problem for target-date fund investors: there is a clear inverse relationship between passive management and one's ability to diversify a target-date fund. Limiting diversification can increase the risk and reduce the Sharpe ratio[1] for these more constrained, less diversified portfolios. We argue that diversification—a key element of risk control and portfolio efficiency used by active target-date managers—is left unattended by passive mangers. Thus, the cost decision can lead to inferior investment decisions and outcomes.

P&I: Over the lifespan of a target-date fund, does the investor's changing risk tolerance change the active/passive dynamic?

Rich Weiss: We don't believe that passive allocations or indexed sleeves offer optimal risk control at any stage of the participant's investment horizon. There is ample academic evidence and real-world experience, not to mention just plain common sense, supporting the idea that an inverse relationship exists between a target-date investor's age and wealth and his or her risk tolerance. The primary avenue for controlling this de-risking process is the glidepath, both at the broad asset class level and the sub-asset class level. So active target-date strategies incorporate this dynamic risk profile into their glidepaths.

Passive strategies, on the other hand, only partially address this declining risk tolerance. It's even possible that sub-asset class allocations within a market-cap-weighted glidepath actually fly in the face of this logic, effectively getting *more* risky as the investor ages. It's a perverse relationship—we believe an unintended one—but an incredibly imprudent side effect of the passive approach, when market capitalizations dictate the portfolio's asset allocation, style allocation, bond duration, and other key characteristics.

P&I: Where do fees fit into the target-date selection process—where would they be appropriately considered?

Rich Weiss: Again, the major driver of risk/return and wealth accumulation over time is a target-date fund's glidepath. We believe that fees play a decreasingly relevant role over time, and are far outweighed by the potential value delivered through glidepath dynamics and appropriate changes in asset allocation. In our view, fees play only a minor role within a very broad cast of investment parameters and risks. Moreover, passive investing imposes significant limitations on diversification and glidepath design, which by definition limit a passive target-date series' ability to address the specific needs and challenges of a given plan's participant base.

In summary, selecting an appropriate target-date series first requires a thorough self-assessment of a plan's objectives and governance structures, as well as an understanding of the participants' demographics, behavior, and attitudes towards risk. After those objectives are understood and documented, then sponsors can conduct a deep-dive review of individual target-date series—their objectives, glidepath designs, breadth and depth of diversification, overall risk management, and expenses. All these factors combined will determine the degree of fit with the overall plan and its participants. ❖

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ACTIVELY INVESTING IN YOUR SUCCESS

More than a half century ago, American Century Investments® was founded with a dedication to active investment management focused on one objective—delivering superior, long-term, risk-adjusted performance. Today, this focus defines our approach to target-date fund management. Featuring a risk-aware glidepath, sound asset allocation and disciplined active management, One Choice℠ Target Date Portfolios seek to provide a smoother ride by limiting volatile return streams in an effort to help more participants achieve retirement success.

American Century Investments®

$150B
AUM as of 6/30/2015

One Choice℠
TARGET DATE PORTFOLIOS

$15B
AUM as of 6/30/2015

ONE CHOICE STANDS OUT

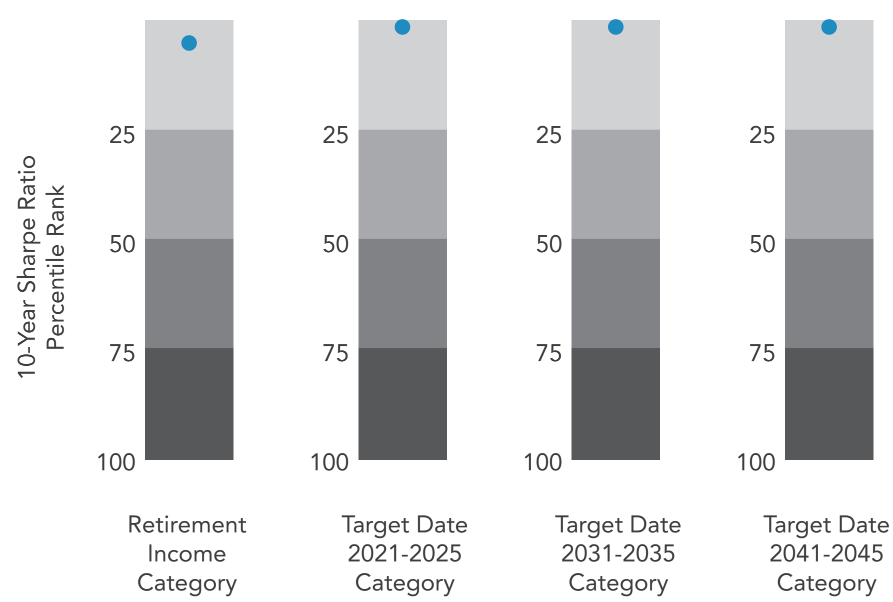
Competitive Risk-Adjusted Returns

Institutional Class	Ticker	Morningstar Category	Overall Rating	Funds in Category
One Choice℠ 2055 Portfolio	ARENX	Target Date 2051+	★★★★	111
One Choice℠ 2050 Portfolio	ARFSX	Target Date 2046-2050	★★★★★	174
One Choice℠ 2045 Portfolio	AOOIX	2014-2045	★★★★★	149
One Choice℠ 2040 Portfolio	ARDSX	2036-2040	★★★★	194
One Choice℠ 2035 Portfolio	ARLIX	2031-2035	★★★★	150
One Choice℠ 2030 Portfolio	ARCSX	2026-2030	★★★★	195
One Choice℠ 2025 Portfolio	ARWFX	2021-2025	★★★★	150
One Choice℠ 2020 Portfolio	ARBSX	2016-2020	★★★★	195
One Choice℠ In Retirement Portfolio	ATTIX	Retirement Income	★★★★★	150

*Morningstar ratings as of 6/30/2015. **2055 Portfolio**: 3-year rating 4 stars out of 111 funds, 5- and 10-year periods not rated. **2050 Portfolio**: 3-year rating 4 stars out of 174 funds, 5-year rating 5 stars out of 132 funds, 10-year period not rated. **2045 Portfolio**: 3-year rating 3 stars out of 149 funds, 5-year rating 5 stars out of 123 funds, 10-year rating 5 stars out 17 funds. **2040 Portfolio**: 3-year rating 3 stars out of 194 funds, 5-year rating 4 stars out of 170 funds, 10-year period not rated. **2035 Portfolio**: 3-year rating 3 stars out of 150 funds, 5-year rating 4 stars out of 124 funds, 10-year rating 5 stars out of 26 funds. **2030 Portfolio**: 3-year rating 3 stars out of 194 funds, 5-year rating 4 stars out of 170 funds, 10-year period not rated. **2025 Portfolio**: 3-year rating 3 stars out of 150 funds, 5-year rating 3 stars out of 124 funds, 10-year rating 5 stars out of 26 funds. **2020 Portfolio**: 3-year rating 3 stars out of 195 funds 5-year rating 4 stars out of 171 funds, 10-year period not rated. **In Retirement Portfolio**: 3-year rating 5 stars out of 150 funds 5-year rating 5 stars out of 143 funds, 10-year rating 5 stars out of 60 funds.*

Morningstar ratings are based upon Institutional class of shares, unless otherwise indicated. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The Overall Morningstar Rating™ for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating™ metrics. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Morningstar percentile ranking is based on the fund's total-return relative to all funds in the category. Past performance is no guarantee of future results.

Top-Decile Sharpe Ratios



Data as of 6/30/2015, Institutional Class. Source: Morningstar. Inception date for 2045, 2035, 2025 and In Retirement is 8/31/2004. Inception date for 2050, 2040, 2030 and 2020 is 5/30/2008. Inception date for 2055 is 3/31/2011. Data presented reflects past performance.

The Sharpe Ratio is a risk-adjusted measure developed by William F. Sharpe, calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the fund's historical risk-adjusted performance. Sharpe Ratios shown for portfolios with 10 years of history. Fund name, 10-year rank/number of funds in category: In Retirement, 8/80 funds; 2025 Portfolio, 1/34 funds; 2035 Portfolio, 1/34 funds; 2045 Portfolio, 1/22 funds. The Morningstar percentile ranking is based on the fund's Sharpe ratio relative to all funds in the category. Past performance is no guarantee of future results.

Vehicles Offered

Mutual Funds (including R6 share class)
Collective Investment Trusts

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A target date is the approximate year when investors plan to retire or start withdrawing their money. The principal value of the investment is not guaranteed at any time, including at the target date. Each target-date portfolio seeks the highest total return consistent with its asset mix. Each year, the asset mix and weightings are adjusted to be more conservative. In general, as the target year approaches, the portfolio's allocation becomes more conservative by decreasing the allocation to stocks and increasing the allocation to bonds and money market instruments.

You should consider the fund's investment objectives, risks, and charges and expenses carefully before you invest. The fund's prospectus or summary prospectus, which can be obtained at americancentury.com, contains this and other information about the fund, and should be read carefully before investing.

[1]The Sharpe Ratio is a risk-adjusted measure developed by William F. Sharpe, calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the fund's historical risk-adjusted performance.

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