



# Target-Date Retirement Funds: The New Defined Contribution Battleground

November 2009

- **The evolution of target-date products will transform the defined contribution competitive landscape.** As target-date options grow, their use of techniques and structures common in the defined benefit marketplace will re-arrange winners and losers in target-date provision.
- **Rapid growth will restructure the asset allocation and packaging of target-date products.** Target-date and target-risk retirement vehicles will attract 80% of new and reallocated flows into defined contribution schemes for the next decade. Target-date funds alone will swell to \$2.6 trillion of assets in 2018 from \$311 billion in 2008.
- **Target-date funds will become the primary source of investment only opportunities,** swelling to more than half the investment-only marketplace by 2018, up from slightly more than 10% today and generating nearly \$13 billion in annual revenues within a decade, more than six times the current amount.
- **Customization and indexation are emerging as the cornerstones of target-date innovation.** Customized target-date options will balloon to nearly \$1 trillion in 2018, from \$53 billion today, led by schemes exceeding \$1 billion in size. More than 80% of off-the-shelf target-date products will be passively managed by 2018.
- **Alternative asset managers and institutional boutiques will vie for customized business.** By 2018 tailor-made target-date funds could place as much as \$600 billion with active fund managers, favoring high-conviction players with real assets and non-correlated returns.
- **Recordkeeper-affiliated target-date fund managers must act aggressively to maintain their economics,** at least at the large end of the marketplace. If they fail to do so, bundled options will shrink to 25% from 44% of all target-date vehicles by 2018. Recordkeepers can strike back by offering their own customized products, creating bundled decumulation strategies and launching proprietary index funds.
- **Solution providers offering indexation and diverse asset allocation stand to gain significantly from target-date innovation.** Bond managers, in particular, could play a key role developing decumulation-oriented target-date funds that appeal to plan sponsors increasingly concerned about providing retirement income options.

## Table of Contents

1. Introduction .....	3
2. First Generation Target-Date Funds: Missing the Mark .....	5
3. Next Generation Target-Date Funds: Cancelling the “Big Put” .....	8
4. Winning Business in the New Target-Date Market: Can the Empires Strike Back? .....	13

## Authorship

### Casey Quirk contributors include:

David J. Bauer, Partner  
Benjamin F. Phillips, Partner  
Justin R. White, Senior Associate

### Casey Quirk Partners:

John F. Casey, Chairman  
David J. Bauer  
Jeb B. Doggett  
Yariv Itah  
Benjamin F. Phillips  
Kevin P. Quirk



Casey, Quirk & Associates provides management consulting services exclusively to investment management firms. The firm specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. The firm draws on more than 40 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to influence change within organizations. Casey Quirk publishes a series of thought-leadership papers on topics of interest generated by ongoing industry research.



Casey Quirk is especially grateful for the assistance of the Profit Sharing/401K Council of America, who helped develop and administer a survey of US plan sponsors that helped further inform our opinions about the defined contribution marketplace. PSCA is a non-profit association of 1,200 companies that sponsor defined contribution plans for five million employees. PSCA ([www.psc.org](http://www.psc.org)) offers unbiased best-practices information, research and technical assistance.

## 1. Introduction

Target-date retirement funds (TDRFs)—also known as lifecycle funds—are investment portfolios that dynamically adjust asset allocations to reduce risk as their shareholders age. Their growth has been encouraged by the Pension Protection Act of 2006, which classifies target-date funds (along with their cousins, target-risk funds) as one of a handful of permitted default investment options within US defined contribution plans that automatically enroll employees.

Our September 2007 whitepaper, *The Brave New World: Winning Product Strategies for a Changing Global Market*, highlighted target-date funds as one of the outcome-oriented product sets that will represent the majority of net new business for fund managers in coming years. The recent financial crisis, however, exposed several flaws not only in the existing first generation of target-date funds, but also in the way that fund managers package them for participants.

Both Congress and clients have begun to scrutinize the construction and value proposition of target-date products, particularly because the average target-date fund lost 32% of its value during 2008. Nearly 90% of respondents to our survey of plan sponsors (see **Acknowledgements**), however, were satisfied with their target-date options to some degree. Such support reflects neither apathy nor blind approval: nearly two-thirds of the sponsors we surveyed said they would consider changes to their target-date vehicles. The results imply that plan sponsors regard their target-date funds as first-generation prototypes: they believe in the idea, but now seek to improve its execution.

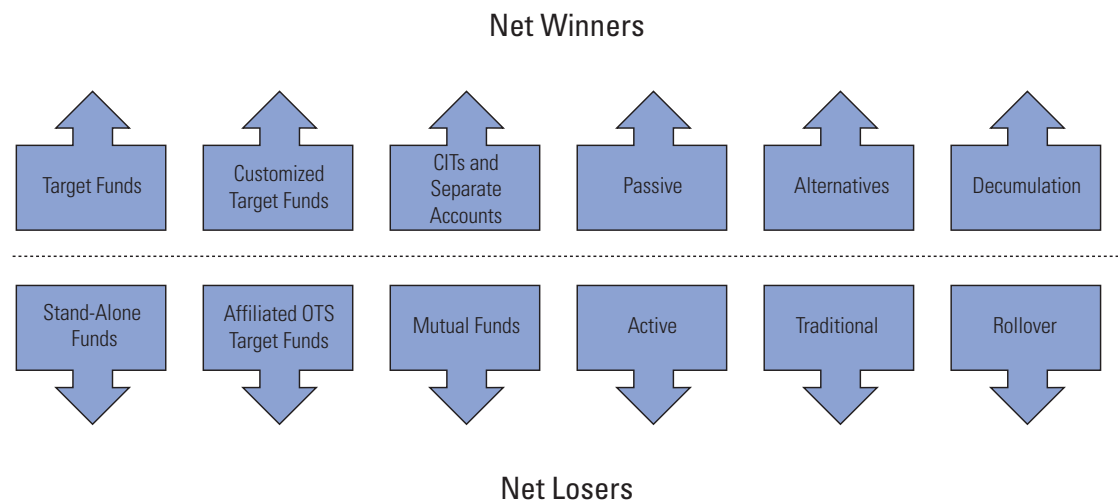
Defined contribution schemes already are driving the innovations required for a second generation of target-date funds, one that addresses some of the faults revealed by the bear market. Plan sponsors are leading this product development, which not only will favor entirely new types of vendors, but also will reshape the defined contribution marketplace.

- Target-date funds will grow to dominate the investment-only marketplace. This will reduce the available opportunity for mutual fund vendors who have relied on defined contribution plans as significant clients for their single-strategy equity and bond products.
- Cost and liability concerns among all but the largest defined contribution plans will encourage the wider use of passively managed target-date products.
- Institutional boutiques and alternatives managers, the same firms now prevalent in the defined benefit landscape, will gain a larger share of a rapidly expanding pool of customized target-date funds among larger plans.
- All firms hoping to compete for defined contribution assets must reassess their target markets, products, distribution approach and positioning.

Further innovation is likely. For a number of reasons, a growing number of plan sponsors are signaling that they want to continue managing participant assets after retirement, and are looking for solutions that assist with decumulation issues and retirement income provision. This creates demand for cradle-to-grave target-date options that also leverage techniques from the defined benefit marketplace, providing asset managers with further opportunities—if they can develop the appropriate solutions.

Exhibit 1

### Key Trends Summary: Winners and Losers in the New Defined Contribution Marketplace



Source: Casey Quirk

Given the different terminology used by various vendors in the defined contribution marketplace, readers should note that in this report:

- **Affiliated**, or **bundled**, target-date products refer to vehicles that are proprietary products offered by a defined contribution recordkeeper. Many of these recordkeepers are asset managers that also now offer their target-date funds independently from the recordkeeping platform; assets gathered in that manner are considered unaffiliated.
- **Unaffiliated**, **third-party**, or **unbundled** target-date products refer to vehicles offered by firms without their own recordkeeping platform. These products form part of the **investment-only** marketplace. The remainder of the investment-only marketplace is largely comprised of stand-alone mutual funds that currently dominate the investment option menus of many defined contribution plans.
- Additionally, **off-the-shelf** (OTS) target-date products are those designed primarily as either mutual funds or collective investment trusts (CITs). They stand apart from **customized** solutions, which are tailor-made for a single client, either from existing platform options or from a new roster of specialist managers.

## 2. First-Generation Target-Date Funds: Missing the Mark

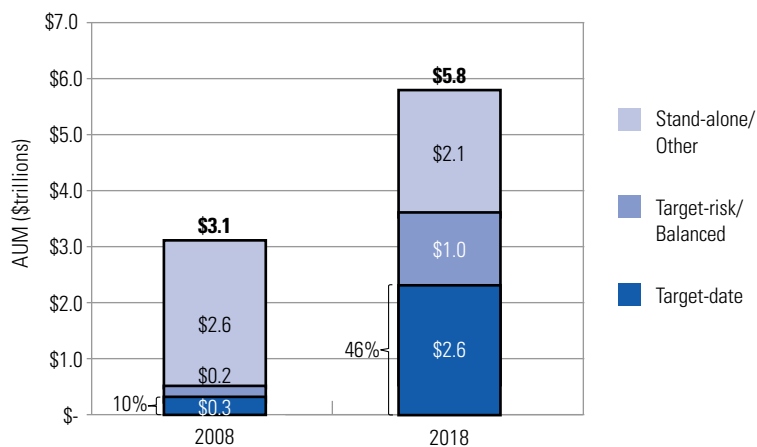
### Growth Catalysts

Target-date funds are becoming the core, if not the sole, product of interest within defined contribution plans. Their eligibility as qualified default investment alternatives under the Pension Protection Act, coupled with their simple one-stop, “set-it-and-forget-it” retirement savings proposition to plan participants, have made them increasingly popular among plans of all sizes. Plan sponsors also feel more comfortable promoting professionally-allocated target-date funds to participants, rather than letting plan members build their own portfolios. Finally, competitive dynamics also have encouraged target-date product growth. Recordkeepers are promoting their in-house target-date products aggressively to stem revenue loss from the widening menu of third-party investment options many have added in recent years.

Consequently, target-date funds benefit from a privileged position, often automatically benefiting from contributions made by new employees enrolled in a defined contribution system. Target-date and target-risk funds combined will represent 80% of net new inflows to defined contribution schemes for the ten years ending December 2018, when target-date funds alone will represent nearly half the assets in defined contribution plans.

Exhibit 2

#### US Defined Contribution Assets by Investment Product



Source: Casey Quirk Analysis

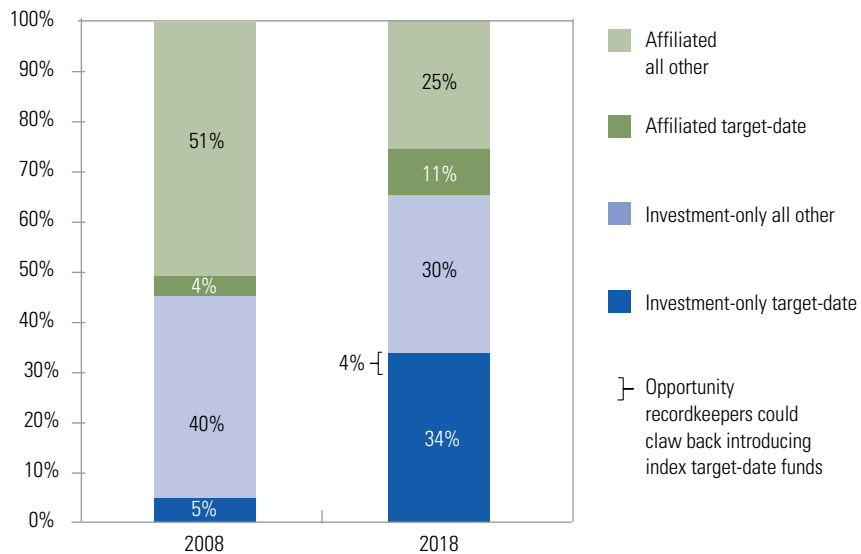
Our estimates likely are conservative. They minimize the impact of so-called re-enrollment—automatically moving all participants in a plan, not just new employees, into the default vehicle, unless they opt out. Although re-enrollment rates were low in 2008, many plans have spent 2009 seeking new recordkeepers, and switching platforms often triggers re-enrollment. If re-enrollment rates increase, wider target-date adoption may occur earlier, but then later growth will slow, creating

little change in the final size of the market in 2018. Our projections also do not fully account for a number of additional catalysts—introduction of automatic-enrollment IRAs and new regulations—that could further turbocharge target-date growth.

The growth of target-date funds profoundly changes the investment-only defined contribution marketplace, a large source of assets and revenues for mutual fund firms. Today, target-date funds comprise slightly more than 10% of investment-only assets. By 2018, however, target-date products will represent more than half of the investment-only marketplace. Learning lessons from the financial crisis, many plan sponsors will seek cheaper or more innovative target-date options for their participants. That shift—and the unbundling it may unleash—will favor target-date vehicles that look notably different from the products available today.

Exhibit 3

### US Defined Contribution Assets by Packaging Format



Source: Casey Quirk Analysis

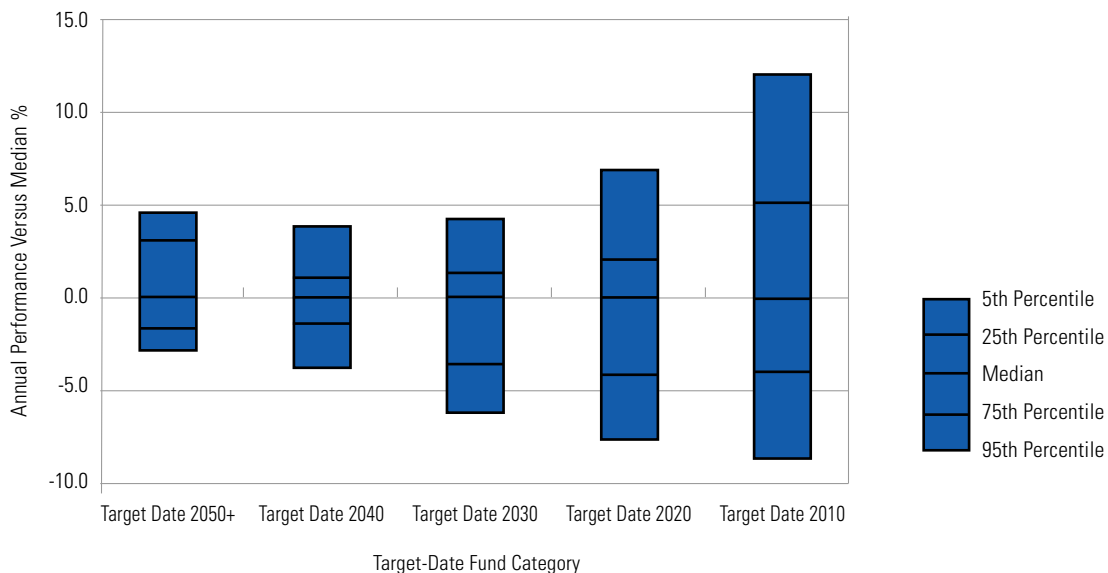
### First-Generation Flaws

The 2008 market crash not only slashed asset levels, but also led to a contraction in participant contributions and the suspension of many employer matching contributions. Attention focused on target-date performance, which was disappointing but not surprising in 2008. The performance dispersion among 2010 target-date funds, in particular, drew the most scrutiny. The label on the 2010 funds implied that they were designed for imminent retirement, and many investors assumed this meant lower-risk portfolios. In actuality, however, the equity exposure within America's 2010 target-date funds ranged broadly from 10% to 65%, although most settled between 40% and 50%. This created a wide difference among returns posted by the 2010 target-date fund vendors.

Angry participants and lawmakers accused target-date fund managers of sins ranging from incompetence to malfeasance. In reality, however, the range of equity allocations within target-date funds reflected the fund managers' different opinions about the maturity of the defined contribution marketplace, and the long-term role of target-date vehicles. Some target-date fund managers assumed their fund shareholders would cash out of their products in 2010, fleeing to less risky, income-oriented instruments. Others felt their customers would remain invested in target-date funds much longer and, therefore, required higher equity allocations for a number of years after retirement. These different opinions (the so-called “to or through” debate), and a widespread failure to communicate them, led to mismanaged customer expectations.

Exhibit 4

### Off-the-Shelf Target-Date Fund Category Performance Spread, 2008



Sources: Strategic Insight, Morningstar, Casey Quirk Analysis

More importantly, however, first-generation target-date funds fail to acknowledge the growing maturity of the defined contribution system. Most target-date funds do not address two key trends now reshaping decision-making processes, and therefore product demand, from defined contribution plan sponsors:

1. **Rising investment sophistication:** Defined contribution plan sponsors are realizing that they and their participants face a broader series of risks that existing products do not adequately mitigate. They also realize that the increasing heft of their target-date options—many of which could increase tenfold in size before 2018—allow them access to a wider array of investment tools.

- Rising focus on decumulation:** Historically, most defined contribution plans have concentrated on accumulation, leaving decumulation and retirement income to vendors in the rollover market. Increasingly, however, a growing number of plan sponsors are adopting decumulation management as an objective and will, therefore, start to seek solutions that help them deal with this process.

These two unfolding trends will drive innovation in target-date products, and will dramatically change the competitive dynamics in the defined contribution marketplace.

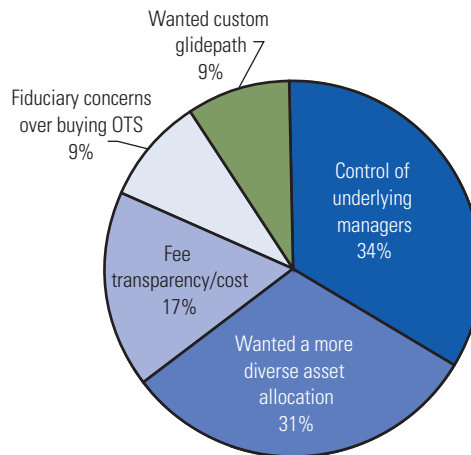
### 3. Next-Generation Target-Date Funds: Cancelling the “Big Put”

#### Sponsor-Directed Innovation

Our September 2007 whitepaper described the global proliferation of defined contribution plans as “the Big Put”: shifting the responsibility for retirement provision from governments and corporations to individuals. Increasingly, however, stakeholders in the first (government) and second (corporate) pillars are realizing that individuals remain poorly equipped to manage their own retirement accumulation or decumulation. A wide range of investment options, previously regarded as a best practice, in retrospect now looks dangerous following the 2008 market crash. And while lawmakers have focused on regulating or changing target-date glidepaths, plan sponsors instead have focused on the types of fund managers overseeing the product and potential new asset classes.

Exhibit 5

Respondents by Reasons For Building a Custom Target-Date Fund



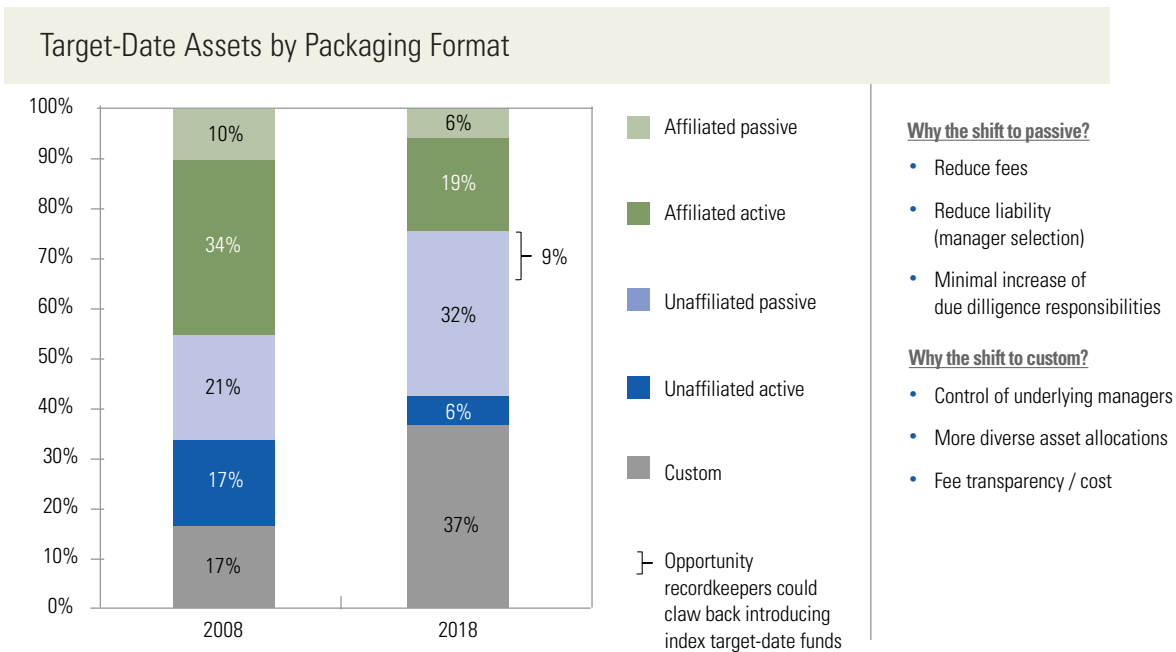
Source: Casey Quirk/PSCA Target-Date Fund Survey March 2009

Three principal concerns are driving many plan sponsors to consider changes to their target-date arrays: **cost containment**, **liability protection** and—among larger plans at least—a desire for greater **diversification** among both asset classes and managers.



When making decisions, many defined contribution plan sponsors seek above all else to mitigate **cost** and **liability** exposure. Because plan sponsors must endorse a default investment option, the risks for smaller plans without the expertise and staff to support robust manager selection and product design have become more palpable. Passive vehicles are usually 50 to 60 basis points cheaper than actively managed counterparts, depending on the packaging used, and remove manager selection risk that could attract litigation in future years.

Exhibit 6



Source: Casey Quirk Analysis

Consequently, most plans that decide to shift to a different off-the-shelf target-date option will select a passive vehicle. Actively managed target-date mutual funds, once the plurality of the investment-only marketplace, will only account for a slim portion of investment-only assets within a decade.

The large-scale shift to passive investing in off-the-shelf target-date products, however, will largely ignore exchange-traded funds (ETFs), except in the small-plan market or among large plans seeking tools to create synthetic exposure to less liquid asset classes (e.g., commodities). As they grow in size, most of the passively managed target-date assets will use CITs or separate accounts as packaging, blunting the pricing advantage of an ETF. An ETF's tax alpha means less within a tax-advantaged defined contribution plan. And defined contribution recordkeeping is built largely on technology designed only to handle daily-valuation vehicles like mutual funds and separate accounts, not intraday-priced ETFs.

### Customization Catalysts

At the large end of the market, however, other issues also become important:

- Large defined contribution plan sponsors often manage sizable, if closed, defined benefit schemes as well, and therefore can leverage their expertise and vendor relationships to create customized target-date funds options more efficiently.

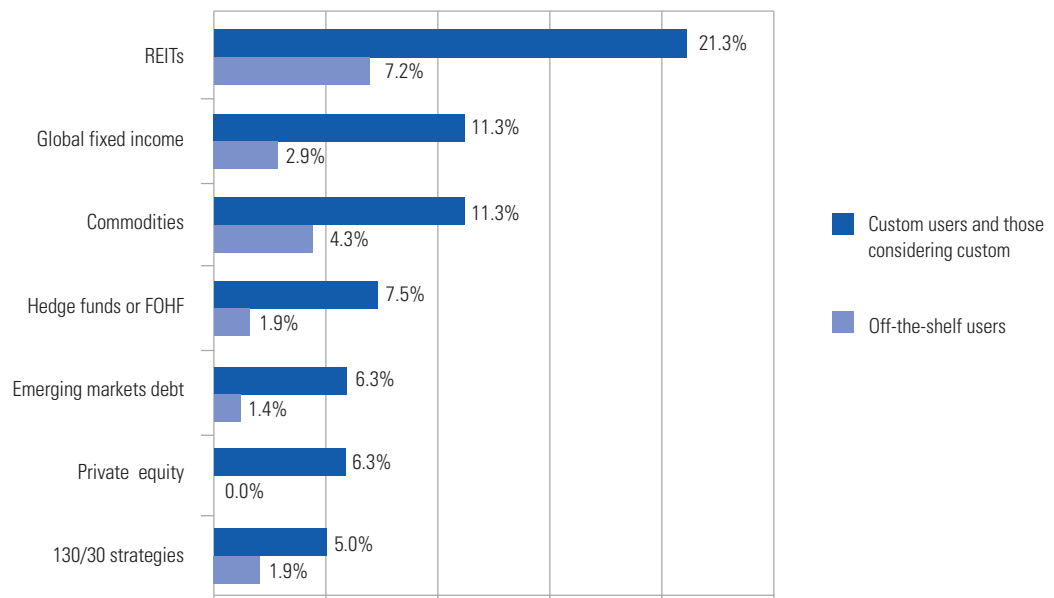
- Their greater size creates pricing power that reduces the fee advantage passive products hold. Additionally, they often are more willing to pay separate and sometimes higher fees to record-keepers on behalf of their participants, reducing a platform’s reluctance to unbundle loss-making administration from high-margin proprietary asset management options.
- Finally, even today, many large plan sponsors cling to the paternalistic view that cutting-edge pension schemes are benefits that retain key talent. One-third of large plans responding to our survey already have deployed customized target-date plans.

A desire for **diversification**, in both asset allocations and manager rosters, is a principal driver of customization. Many customization initiatives begin with plan sponsors mixing favorite options from their existing investment menu to expand the range of firms and asset classes embraced by their default options. The glidepath, so far a primary focus of attention from lawmakers and regulators, has not been a strong catalyst for reform.

Plan sponsors increasingly believe that the current array of asset classes that existing target-date options provide is likely insufficient to mitigate the broader array of risks they feel their participants now face, including prolonged longevity, more volatile markets, and potential inflation. Such fears are reflected in the asset classes they want to add to their target-date options. Survey respondents already offering customized solutions are the most aggressive, with a wider proportion of such plans willing to consider alternative investments, real assets, and long-short options. Interviews also found that Treasury inflation-protected securities (TIPS), unlisted on our menu of potential options, list among highly sought additional asset classes.

Exhibit 7

### Respondents by Additional Asset Classes Desired



Note: Multiple responses permitted.

Source: Casey Quirk/PSCA Target-Date Fund Survey March 2009

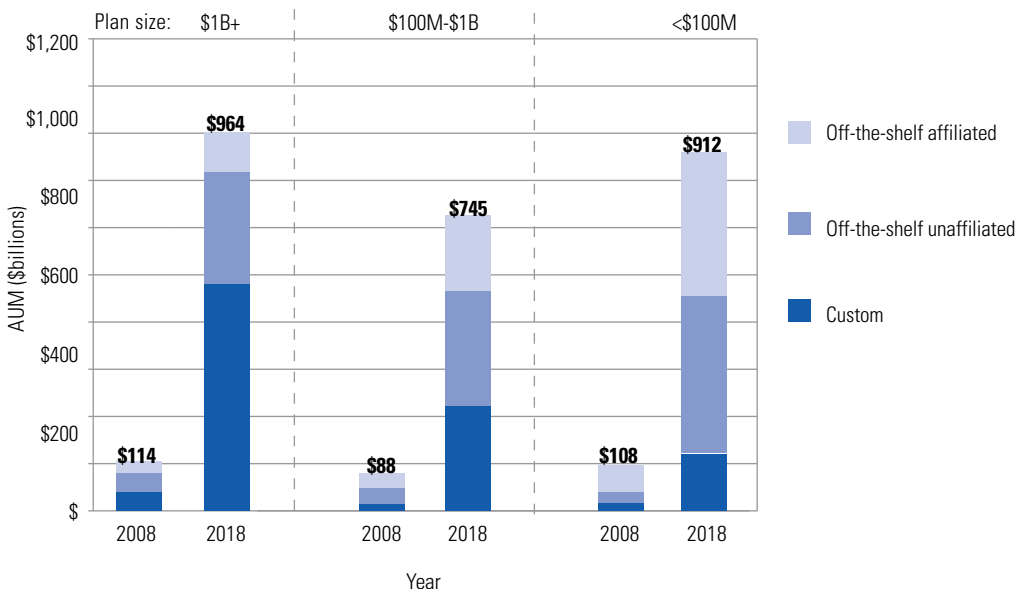
## Marketplace Impact

Plan size will be the greatest factor in determining how a defined contribution scheme will change its target-date options:

- The largest plans, those with more than \$1 billion in assets, will implement the greatest degree of target-date customization. Often co-managing defined benefit and defined contribution schemes, these sponsors have the technical expertise to hire a wider range of institutional boutiques, and also have the sizable asset pools required to attract the interest of separate account managers.
- Some medium-sized plans, usually holding between \$250 million and \$1 billion, want to build custom target-date vehicles, but still lack the size required to do so. A large number of these plans will shift from their existing recordkeeper's actively managed product to passively managed third-party off-the-shelf target date funds. Plans with between \$60 million and \$250 million will shift from active to passive target-date plans as a more permanent solution.
- Plans with less than \$60 million in assets cannot provide enough assets to attract any custom or third-party options, and few small plan sponsors have interest in exploring options beyond the recordkeeper's bundled products.

Exhibit 8

### Target-Date Assets by Plan Size and Packaging Format



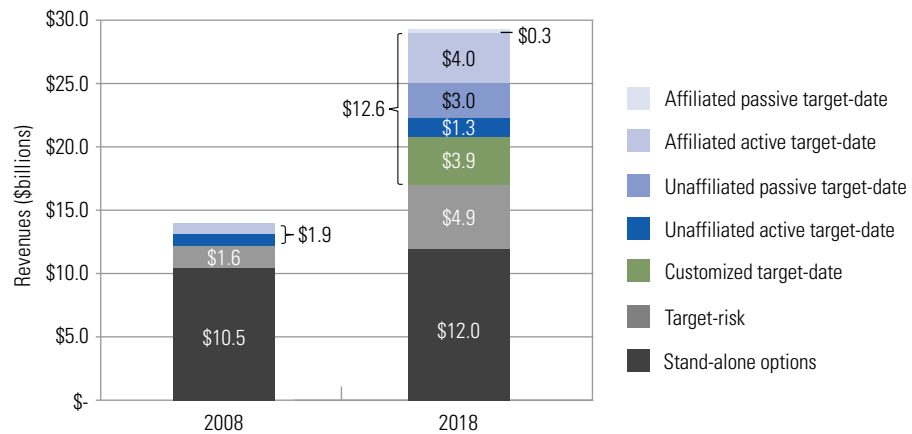
Source: Casey Quirk Analysis

The expansion and innovation of target-date funds changes the opportunity set for all players in the defined contribution marketplace. Today, target-date vehicles of all types account for an estimated \$2 billion of annual revenue, a sliver of the revenue that stand-alone defined contribution

investment options generate, mostly for mutual fund managers. By 2018, however, target-date funds will comprise nearly \$13 billion of annual revenue. Stand-alone options will generate less revenue than target-date funds, reflecting a take-away game among legacy players—dependent on inertia and characterized by its high cost of client acquisition.

Exhibit 9

### Estimated Defined Contribution Revenues by Packaging



Note: De minimus passive and customized target-date revenue in 2008.

Assumes customized vehicles index 40% of assets.

Source: Casey Quirk Analysis

The evolution of target-date funds will create three distinct opportunities for asset managers:

- **Customized vehicles** will represent as much as 38% of assets and 31% of potential annual target-date revenues by 2018. About \$600 billion of such options will reside with active fund managers, many of which will be boutiques that offer non-correlated returns, real assets, alternative investments or market-neutral strategies designed to provide more cutting-edge investment results for plan sponsors.
- **Index vehicles** will gather an estimated 30% of potential annual target-date revenues in 2018, with off-the-shelf vehicles accounting for nearly 90% of those fees (customized products will comprise the remainder). A proportion of assets currently managed in large-cap actively managed options with low tracking error will shift to cheaper, more defensible index options by 2018.
- **Actively managed off-the-shelf target-date products** will find themselves confined to the remaining 42% of revenue, with much of this coming from bundled funds offered to the smaller end of the defined contribution marketplace. The market opportunity for third-party actively managed target-date mutual funds and collective investment trusts will shrink dramatically in relative terms, from 26% to 10% of defined contribution revenues.

## 4. Winning Business in the New Target-Date Market: Can the Empires Strike Back?

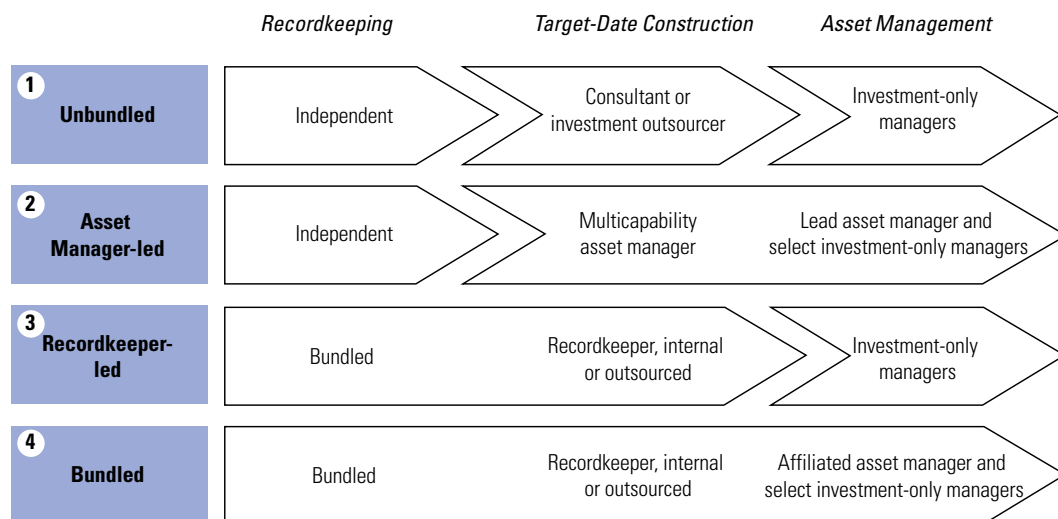
### The New Battleground: Off-the-Shelf Target-Date Products

The growth of target-dates will split the marketplace of plan sponsors into three distinct segments. At the upper end of the marketplace will sit the largest plans, many of which have the wherewithal and desire to take a fully unbundled approach to target-date assembly: an allocator—be it a consultant or investments outsourcing firm—marrying third-party asset managers to an open-architecture recordkeeping platform. At the other end, as discussed earlier, are small plans which lack the pricing power to interest any target-date vendor other than the ones attached to their platform.

The true battleground will center over off-the-shelf products, which by 2018 will account for more than 60% of target-date assets and nearly 70% of all target-date revenues. Asset managers, particularly index firms, will pursue investment-only target-date business aggressively. Conversely, recordkeepers will seek to preserve and expand their bundled target-date business by changing their affiliated target-date options to meet client demands. For some, this will involve turning to subadvisors to handle some, if not all, of the asset management duties.

Exhibit 10

#### Target-Date Assembly Models



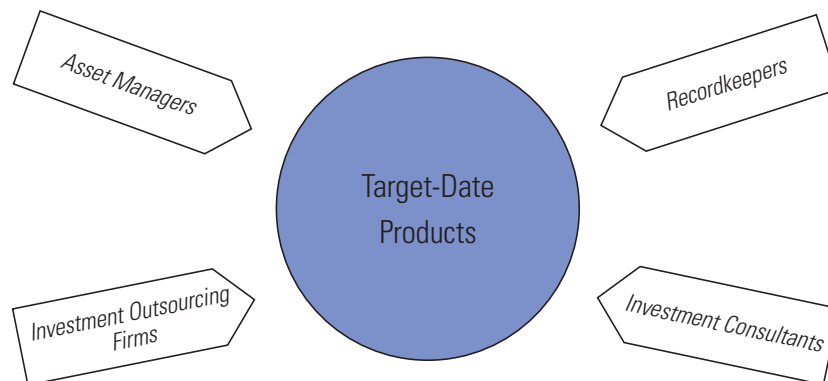
Source: Casey Quirk

Four sets of vendors have an interest in building target-date funds: **consultants, investments outsourcing firms, recordkeepers, and asset managers.**

- **Investment consultants** continue to indicate they regard target-date funds as a natural growth market for their services. They already play a key role in the customized target-date marketplace, constructing half the tailor-made target-date options that survey respondents reported. Consultants have driven customized target-date fund construction as part of fee reviews they undertake for plans, as a shift to institutional managers often results in institutional pricing. But it is unlikely that any but the largest plan sponsors, many of which already leverage investment consultants for their companion defined benefit schemes, will pay consultants a premium for simply constructing glidepaths for target-date funds.
- **Investments outsourcing firms**, conversely, may find opportunities in the target-date market, creating off-the-shelf target-date options from their existing array of third-party managers. As they already have awarded other institutional mandates to their roster, outsourcing firms can leverage scale unavailable to investment consultants, securing lower subadvisor fees and generating more attractive assembly margins for themselves. (Our December 2008 whitepaper, *The New Gatekeepers: Winning Business Models for Investments Outsourcing*, provides more details about this market segment.)
- **Recordkeepers**, particularly those affiliated with fund managers, are seeking to maintain their current control of marketshare. At year-end 2008, the three largest vendors of off-the-shelf target-date mutual funds, together comprising some 70% of marketshare, all ran recordkeeping businesses as well, deriving the majority of their target-date assets from these platforms.
- **Asset managers** will use an investment-only approach to tackle the defined contribution marketplace. While most target open-architecture platforms, a widening number will seek to convince plan sponsors that it makes sense to keep their recordkeeper, but replace the platform's poorly performing, or more expensive, target-date funds.

Exhibit 11

### Competitors in Target-Date Product Assembly



Source: Casey Quirk

Unlike in other asset management market segments, investment performance is not as transparent a yardstick for comparing target-date products. Target-date funds have time horizons measured in decades, and it remains uncertain exactly what combination of high returns and low volatility will win the race. Most plan sponsors will select their off-the-shelf target date funds based on:

- whether assets are managed passively or not;
- the institutional quality of the underlying fund managers;
- the asset allocation method, particularly the diversity of underlying asset classes;
- the rigor, particularly quantitative, in determining the glide path;
- expectations set by the product, and whether they are met;
- and most importantly, cost.

### **Unbundling and Rebundling**

Recordkeepers, asset managers and other target-date assemblers will compete for target-date business on several fronts. The rise of customized and indexed target-date vehicles will trigger further unbundling in the defined contribution marketplace. Until recently, only two of the ten largest recordkeeping platforms offered proprietary indexed target-date funds, and few recordkeepers with affiliated product actively supported customization initiatives. Among survey respondents with customized target-date vehicles, only 22% received assistance from a recordkeeper.

This unbundling challenges the economics of most current recordkeepers in the marketplace. Plan administration only generates roughly 30% of revenues from defined contribution plans, with asset management representing the rest. But only recordkeepers for the smallest defined contribution plans will avoid the pressures that customization and indexation will create.

Asset managers gathering most of their target-date revenues through affiliated recordkeepers only will be able to protect their market share by using a combination of the following competitive responses:

- Offering affiliated passive target-date options by 2018, a move several recordkeepers already have started pursuing. We estimate that recordkeepers could claw nearly \$235 billion of assets back into affiliated target-date options if they aggressively launch indexed vehicles.
- Developing customization initiatives that prevent consultants and other asset managers from disintermediating their business. Doing so also could inject a higher portion of higher-margin proprietary products into tailor-made solutions.
- Creating off-the-shelf target date products that blend proprietary and nonproprietary products to form a more diverse and competitive asset allocation.

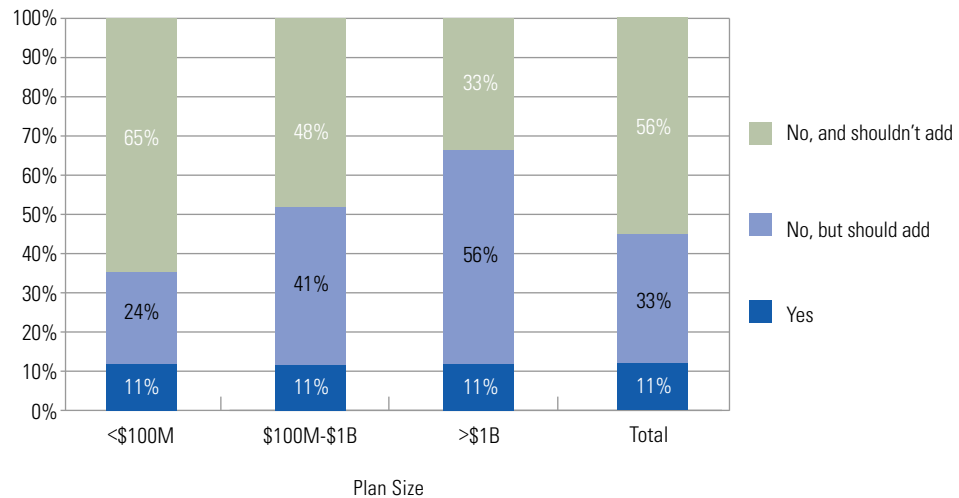
- Supporting decumulation solutions and retirement income products that plan sponsors increasingly desire as part of their offer to participants. This move is the most difficult to execute, but could have the longest-lasting impact on the defined contribution marketplace.

### Creating Incentives for Protecting Retirement Income

For years, discussions about retirement income have evoked a quote (about the weather) attributed to Mark Twain: “Everyone talks about it, but no one does anything about it.” Only 11% of survey respondents, distributed relatively evenly across size cohorts, offer any type of retirement income product, be it some form of annuity, payout fund or income-generating vehicle.

Exhibit 12

#### Respondents by Retirement Income Products Offered



Note: Reflects answer to question: “Do you offer an annuity or payout product in your plan?”

Source: Casey Quirk/PSCA Target-Date Fund Survey 2009

A majority of large plans, however, want to add such income products to their plans. Large plans increasingly realize that the imminent retirement of Baby Boomers threatens their scheme size—and their purchasing power with fund managers, recordkeepers and other service providers. Offering income products keeps assets on the recordkeeping platform and maintains scale that helps create negotiating leverage. A wide majority of survey respondents with more than \$1 billion of assets under administration said they seek to keep participant assets in their plan following retirement.

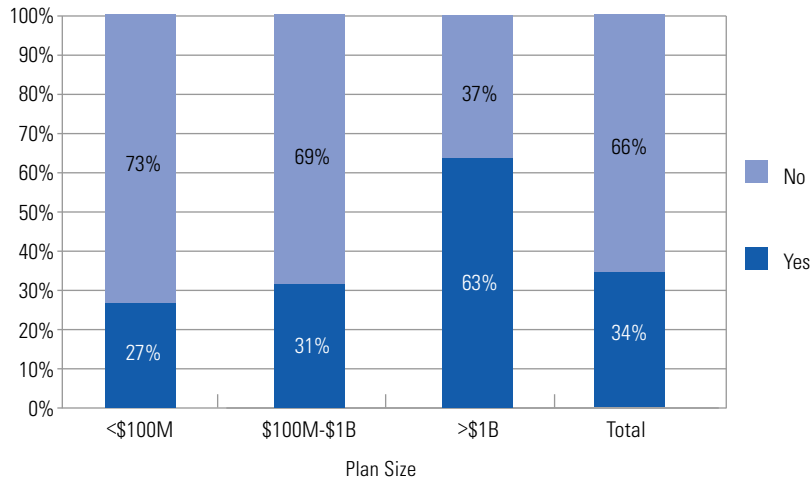
Admittedly, many corporate CEOs and CFOs may balk at the implied (if not actual) liability such a strategy creates. Nevertheless, in interviews many plan sponsors pointed to other, less quantitative, incentives to support decumulation within their schemes. Some believe decumulation support is



a best practice that retains key talent, particularly among key executives who, in many cases, are aging Baby Boomers. Many plan sponsors also cite fears of reputational, if not legal, liability for participants discharged without any assistance regarding retirement income solutions.

Exhibit 13

### Respondents by Desire to Retain Participant Assets Post-Retirement



Note: Reflects answer to question: "Do you seek to retain and service employee accounts post-retirement?"

Source: Casey Quirk/PSCA Target-Date Fund Survey 2009

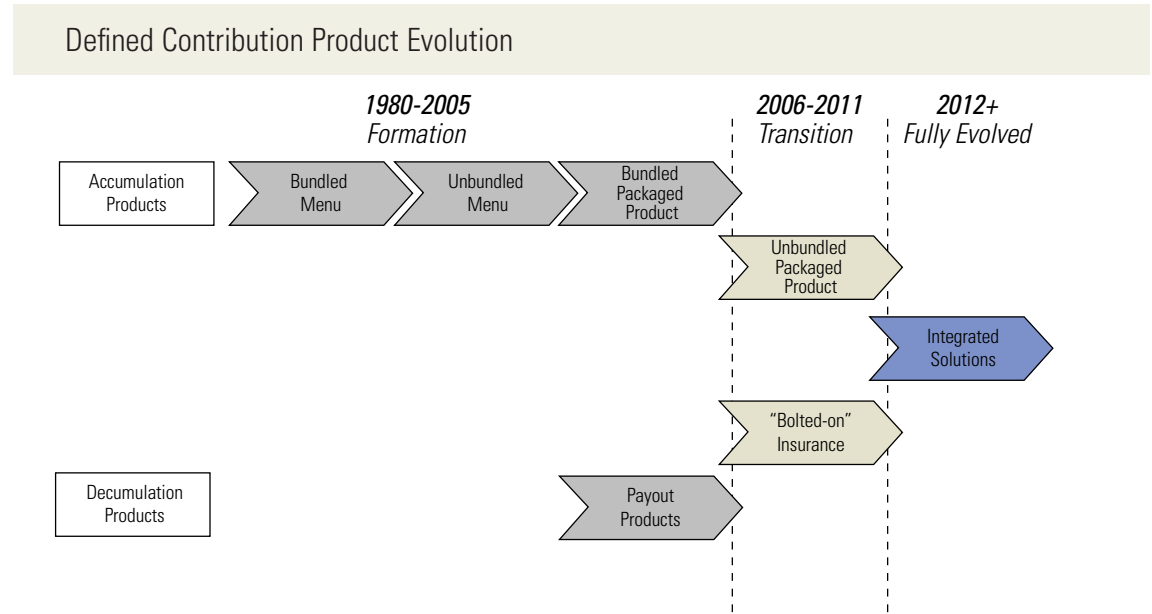
Should such a trend develop, however, it would have profound repercussions for defined contribution plans. Creating products and solutions that keep participants on the platform following retirement would make defined contribution plans larger over time, mitigating the asset depletion currently expected from the imminent retirement of Baby Boomers. Additionally, asset retention by recordkeepers could curb rollover IRA flows, impacting one of the largest marketplaces for mutual fund managers.

American regulators are mulling new rules that would support automatically enrolling plan participants in annuities, and in the United Kingdom, retiring employees must purchase an annuity. Without this government intervention, however, capital markets could play a greater role than insurers in providing retirement income. Most surveys find that sponsors and participants regard annuities as cumbersome and expensive to provide.

The increasing concentration of defined contribution assets in target-date vehicles, and their increasing use of institutional-grade product vehicles and strategies rather than simply differently-priced mutual funds, will create portfolios large enough to deploy a wider array of decumulation strategies that leverage hedging and liability-driven investment (LDI) techniques to most cost-effectively generate income. Asset managers and investment banks may feel more comfortable than insurers in designing and offering these products.

Asset managers could create decumulation solutions by augmenting target-date portfolios with either interest swap overlays or hedge portfolios that provide exposure to long-duration fixed-income benchmarks. Tighter integration could take place by integrating long-duration bonds, or exchanged-traded funds replicating their performance, directly into the target-date portfolios. Optimally, the result would be cradle-to-grave target-date vehicles.

Exhibit 14



Source: Casey Quirk

### Critical Success Factors

Two types of asset managers will experience success in the target-date marketplace.

**Multicapability asset managers** will offer many of the tools required to build the broad asset mixes and LDI-like decumulation solutions we expect plan sponsors will want in their off-the-shelf target-date options. Such managers will be large, comfortable with derivatives, and likely anchored in either fixed income assets, index products, or both. Bond managers could have particular advantages if they can offer inflation-protected and long-duration securities, mitigating both inflation and longevity risk.

The other set of winners will be **specialty asset managers**, who will differentiate themselves by providing significant non-correlated alpha for customized target-date vehicles. These firms will support the institutional packaging and client servicing that large plans, their primary targets, demand.

Alternative asset managers, in particular, could realize significant new business from customized target-date product assemblers looking for a wider array of products. Roughly 30% of survey respondents with customized target-date options expressed interest in adding alternative

investments, including hedge funds, private equity, real estate, long-extension, commodities, and inflation-hedging instruments. Most survey participants admitted employee education would be a considerable hurdle, but alternative asset managers willing to field the client service teams necessary to support defined contribution clients could take a substantial chunk of the \$400 billion to \$600 billion we expect customized target-date assemblers will award to active fund managers by 2018.

Multicapability and specialty asset managers will share several success characteristics, often learned from their experience servicing defined benefit plans. The evolution of target-date funds will transform defined contribution from a quasi-retail to a fully institutional marketplace. Sales will become more technical, more reliant on interaction with the sponsor rather than participants, and more intertwined with actuarial, risk management, and capital markets skills.

Knowledge of the sponsor’s long-term objectives and risk tolerance will be a key advantage that investments outsourcing vendors, recordkeepers and to some degree investment consultants already have. To effectively compete for target-date assets, these players will likely have to secure necessary new skills in wider asset allocation, indexing, and decumulation through organic development, partnership, or acquisition.

Exhibit 15

### Critical Success Factors for Target-Date Asset-Gathering: Asset Managers

At least five provider types will compete for market share

		Multi Capability Asset Managers	Specialty Asset Managers	Recordkeepers	Consultants	Investment Outsourcers
Opportunity	OTS target-date	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Custom target-date	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Investment only	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Critical Success Factors	Investments quality - focused	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Investments quality - broad	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Asset allocation skill	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Manager selection skill	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Distribution	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

Source: Casey Quirk

In the long term, the effects on vendor concentration in the defined contribution marketplace will become noticeable, especially as recordkeeping platforms continue to consolidate and reduce the number of gatekeepers in the marketplace.

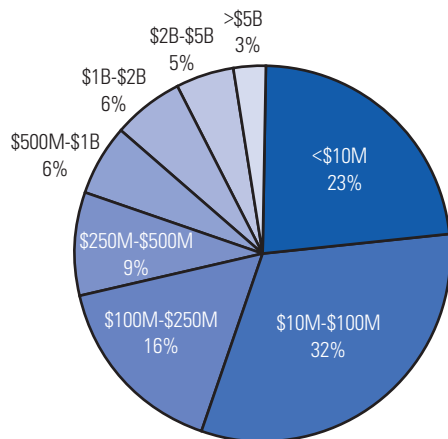
- A small cadre of solution providers will control most of the revenue stemming from passive target-date products, as well as decumulation products as they emerge. This will prove critical as decumulation strategies represent a secular trend in target-date product innovation that is gathering steam regardless of action on Capitol Hill.
- Recordkeeper-affiliated fund managers will have to transform their target-date options into solutions that are either (or preferably both) innovative and cost-effective to mitigate asset loss to investment-only providers. Failure to develop a strong competitive response could significantly weaken these fund managers, as most inflows through defined contribution plans shift to target-date products.
- The actively managed proportion of the growing customized marketplace will be highly fragmented among boutiques and other specialist component providers, and will represent the most revenue and profit per dollar under management.
- The shrinking proportion of target-date assets within actively managed mutual funds, the current bulk of today's target-date marketplace, will reside with affiliated products, as well as a few proven investment-only competitors.

Asset managers of all sizes must realize that within ten years the defined contribution system will demand far different things from its asset managers, and likely will start looking for providers with different skill sets. Fund managers who do not realize this could either miss substantial opportunities or, even worse, suffer widespread defections from their client bases. Recordkeepers who do not adjust their business models for these unfolding trends also will be left behind. These dramatic changes not only will affect the vendors servicing America's defined contribution plans, but also will impact defined contribution scheme participants with profound—and hopefully salutary—results.

### **Acknowledgements**

Our conclusions regarding target-date funds have been informed by detailed analyses of target-date product data and interviews with more than 30 thought leaders in the defined contribution marketplace. Our research also has benefited greatly from the cooperation of the Profit Sharing/401k Council of America, who helped us administer a survey of more than 400 US defined contribution plan sponsors in March 2009.

## Respondents by Plan Size



Source: Casey Quirk/PSCA Target-Date Fund Survey 2009

Casey Quirk would like to thank all the respondents to this year's Casey Quirk/PSCA Target-Date Survey, as well as the following executives for their participation:

Interviewee	Firm	Title
John Ameriks	The Vanguard Group	Principal, Investment Counseling & Research
Rob Capone	BNY Mellon Asset Management	President, Retirement and Sub Advisory Group
Jerome Clark	T. Rowe Price Associates	Portfolio Manager, T. Rowe Price Retirement Funds
Joshua R. Cohen	Russell Investment Group	Senior Consultant, Americas Institutional
Anne Coveney	Putnam Investments	Managing Director, Market Planning
Richard Davies	AllianceBernstein Defined Contribution Investments	Head, Product Strategy
Chris DeMeo	Watson Wyatt Investment Consulting	Division Practice Leader - East
Cynthia Egan	T. Rowe Price Retirement Plan Services	President

<b>Interviewee</b>	<b>Firm</b>	<b>Title</b>
Nick Elward	Fidelity Investments	Vice President, Investment Product Management
David Embry	JPMorgan Retirement Plan Services	Managing Director, Institutional Sales & Sponsor Services
Michael Falk	ProManage LLC	Vice President, Chief Investment Officer
Seth Finkelstein	ING Investment Management	Senior Vice President, Portfolio Manager
Mark Friebe	Pyramis Global Advisors	Senior Vice President, Head of Asset Allocation
Grant Gardner	Russell Investment Group	Senior Balanced Funds Strategist
Todd Glickson	Principal Global Investors	Managing Director, Product Development and Strategy
Chris Herman	Old Mutual Asset Management	Senior Vice President, Director of Product Development
Pamela Hess	Hewitt Associates	Director of Retirement Research
P. MacKenzie Hurd	Capital Guardian Trust Company	Vice President, Defined Contribution Specialist
Anne Lester	JPMorgan Asset Management	Managing Director, Global Multi Asset Group
Lori Lucas	Callan Associates	Executive Vice President, Defined Contribution Practice Leader
Christopher Lyon	Rocaton Investment Advisors	Partner
Kristi Mitchem	Barclays Global Investors	Managing Director, Head of US Defined Contribution
John Payne	UBS Global Asset Management	Executive Director, Head of Alliances & Distribution, DC & Retirement Solutions Group
Stacy Schaus	PIMCO	Senior Vice President, DC Practice Leader
Paul Van Heest	TIAA-CREF	Senior Vice President, Product Development
Cindy Vogl	UBS Global Asset Management	Executive Director, Product Management

This page intentionally left blank

# Target-Date Retirement Funds: The New Defined Contribution Battleground

November 2009



John F. Casey, Chairman  
David J. Bauer, Partner  
Jeb B. Doggett, Partner  
Yariv Itah, Partner  
Benjamin F. Phillips, Partner  
Kevin P. Quirk, Partner

Casey, Quirk & Associates provides management consulting services exclusively to investment management firms. The firm specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. The firm draws on more than 40 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to influence change within organizations. Casey Quirk publishes a series of thought-leadership papers on topics of interest generated by ongoing industry research. To discuss this whitepaper, please contact:

David J. Bauer Partner d.bauer@caseyquirk.com 203-899-3032	Benjamin F. Phillips Partner b.phillips@caseyquirk.com 917-476-2140	Justin R. White Senior Associate j.white@caseyquirk.com 203-899-3044
---	--	---

Casey, Quirk & Associates  
19 Old King's Highway South  
Darien, CT 06820  
www.caseyquirk.com

For more information, please visit [www.caseyquirk.com](http://www.caseyquirk.com) or contact us directly.