

Living with Target-Date Funds

By Randy Myers

Over the past decade, target-date funds have grown to account for about 20 percent of the assets in defined contribution plans. By some estimates, that figure could double by 2018. That makes figuring out how to thrive alongside target-date funds one of the most important challenges facing the stable value industry.

It also was the headline topic in October when seven leaders from the stable value industry participated in a roundtable discussion of the industry's challenges and opportunities during the 2014 SVIA Fall Forum. Participants in the discussion included Mark Auriemma, vice president, State Street Bank & Trust Co.; LeAnn Bickel, head of stable value contract administration, Invesco Advisors; Nick Gage, senior director, Galliard Capital Management; Susan Graef, principal, portfolio manager and head of the stable value management team, Vanguard Group; Aruna Hobbs, senior managing director, investments, for MassMutual; Mike Sipper, director, stable value investments, New York Life Investment Management; and Gary Ward, senior vice president and head of stable value, Prudential Retirement.

It will be important for stable value funds to become a part of the target-date landscape, was the panelist consensus. While stable value funds can't be incorporated into retail target-date funds that are structured as mutual funds and invest only in other mutual funds, they can be a component of custom target-date funds that larger plan sponsors build from their own core investment options. Many larger retirement plan sponsors have already built such funds. Bickel noted that her firm has a number of 529 college savings plans on its client roster, and they, too, offer stable value funds as investment options.

Galliard's Gage noted that about 15 percent of his firm's separate account clients already offer a custom balanced fund or target-date fund, and roughly half offer a managed account program. As those investment options become more popular, he said, they'll capture even more of plan participants' contributions to their retirement accounts. "That's why we're working with stable value issuers and our clients to make sure they utilize stable value within those products, so we are capturing those new dollars," he said.

Ward said Prudential Retirement sees target-date funds as a "huge opportunity" for the stable value industry over the long term as they become more popular not only in defined contribution retirement savings plans but also in other markets, including the 529 college savings plan market and perhaps in international and health savings markets, too.

New York Life agrees, Sipper said. He added that stable value issuers who want to move into the target-date space should do so with their eyes open to the associated risks. Among the factors his firm monitors, he says, are the size of the stable value allocation within custom target-date funds relative to the overall size of the stable value fund in the same plan, and the rebalancing risk associated with a target-date fund. He explained that target-date fund managers periodically rebalance their portfolios to keep them aligned

with their asset allocation targets, and if a particular asset class undergoes a period of sharp underperformance the fund manager may need to sell some better-performing assets—perhaps stable value—and reinvest the proceeds into the lagging asset class. Depending upon market conditions, this could be a stress on the stable value fund.

"We'll also look at the target-date fund and the asset classes involved," Sipper said. "We'll look at the ratio of the risky asset classes to the non-risky asset classes. And we'll look at diversification, not just at the asset-class level but also at the subsector level, to make sure those asset classes are truly diversified."

MassMutual's Hobbs noted that several factors work to mitigate the risks associated with having stable value funds in target-date funds. Rebalancing risk is offset in part, she said, by the fact that a target-date fund by nature is always moving over time toward a more conservative asset mix. She also noted that during periods when equity markets are going up, target-date funds do not experience a high volume of outgoing transfers the way a stand-alone stable value fund might.

Hobbs also noted that target-date funds don't come with any type of principal protection, and asked what issues if any that presents. Sipper said that because adding a stable value component to a target-date fund might mitigate some of its volatility, it could help investors stick with their investments during periods of market turmoil. Ward said it is incumbent upon stable value providers to articulate their product's impact on volatility in target-date funds.

The panelists generally agreed that it would be good if the stable value industry can devise a relatively simple and standard way to manage rebalancing risk within target-date funds so that their product remains palatable to wrap issuers and target-date managers. "We don't want to over-engineer the process," said State Street's Auriemma.

The panelists also weighed in on whether they are seeing some impact from the new rules for money market mutual funds, which among other things allow non-government funds to impose redemption fees or temporarily suspend redemptions if their liquid assets fall below 30 percent of their total assets. Bickel said Invesco had not heard from any plan sponsor clients on that topic, perhaps because money market funds have two years to comply with the new rules. She also noted that relatively few of Invesco's plan sponsor clients offer money market funds to their plan participants. On the other hand, she said, Invesco is talking with its clients about the makeup of the short-term investment funds they maintain within their stable value funds to see how those funds might be impacted by the rule changes.

Prudential, Ward said, is recommending that its plan sponsor clients use the debut of the new rules as an opportunity to reassess their investment lineup and their choice of a capital preservation product for their plans. **SVIA**