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Target date funds: Who is using them and how are they being used?

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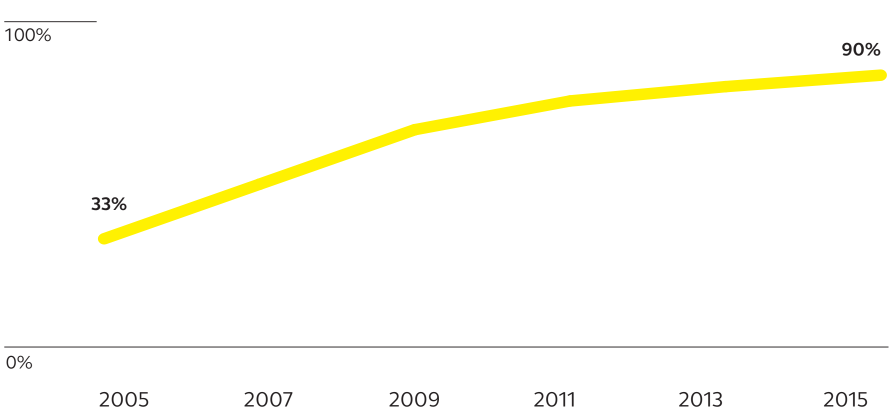
Within defined contribution (DC) plans, the past 10 years can be described as the decade of the target date fund (TDF). Aided in part by the Pension Protection Act of 2006, sponsors added TDFs to plans in droves and participants flocked to them. With their "all-in" investment simplicity and automated de-risking glide paths, TDFs were seen as a panacea for the investing woes of DC plan participants. However, with years of usage data under our belt, Alight Solutions finds that TDFs are actually more of a blunt instrument. Few would argue that they are worse for participants than stable value or money market funds—long the default investment options for plans before TDFs arrived. But we have discovered that TDFs are not being used as the turnkey solution they were designed to be.

This paper shares data from over 1.5 million TDF users across roughly 100 large DC plans to show the profile of a typical TDF user, the prevalence of partial TDF users in plans, and the impact of automatic enrollment on TDF usage. It is our hope that this data will help plan sponsors and the DC industry determine if TDFs are an ideal long-term solution for plan participants.

Target date funds are nearly ubiquitous in DC plans

Over the past decade, target date funds have grown to the point where they have now become a staple in DC plans. In 2005, only one out of every three plans provided a TDF. Now, the percentage is 90% and is expected to grow even higher.[1]

Percentage of plans offering TDFs



The vast majority of DC participants are using target date funds

Participant usage of TDFs has grown hand in hand with employer adoption. We now find that seven out of every 10 actively enrolled participants invest a portion of their balances in a TDF. With such popularity, it should come as no surprise that TDFs are popular across all demographics. They tend to be most favored by participants who are younger, are lower paid or have shorter tenure.

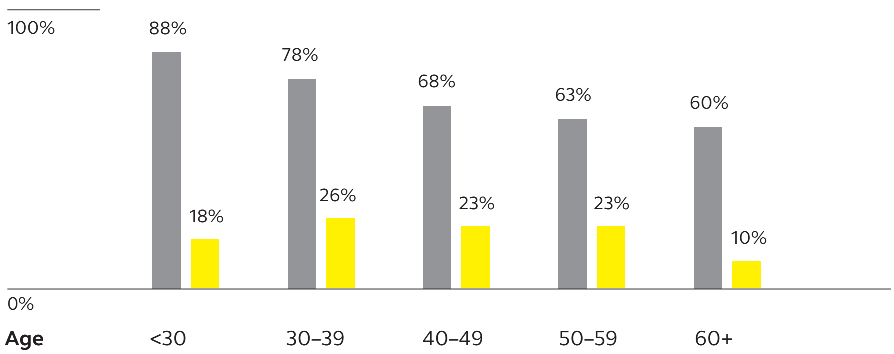
When we look at the "average" actively employed TDF investor, we find that "she" has the following characteristics (females barely edge out males—50.3% versus 49.7%):

Average plan balance	**$69,000**
Average age	**43**
Average tenure (years)	**9**
Average salary	**$54,000**
Average asset allocation to TDFs	**71%**

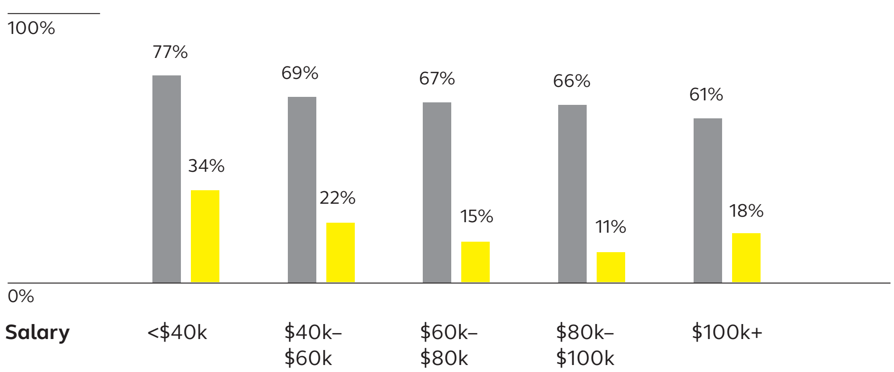
Actively employed participants using TDFs

Percentage of participants
Distribution of investors

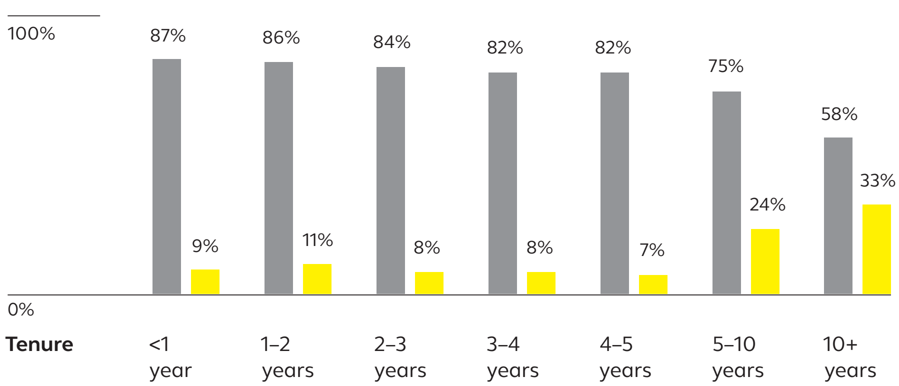
By age



By salary



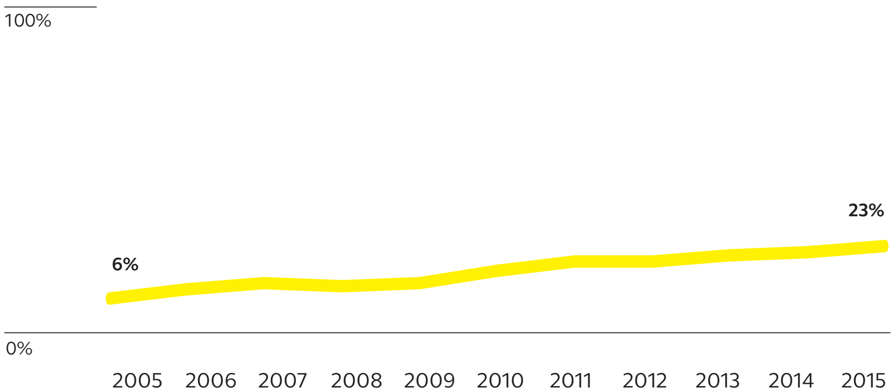
By tenure (years)



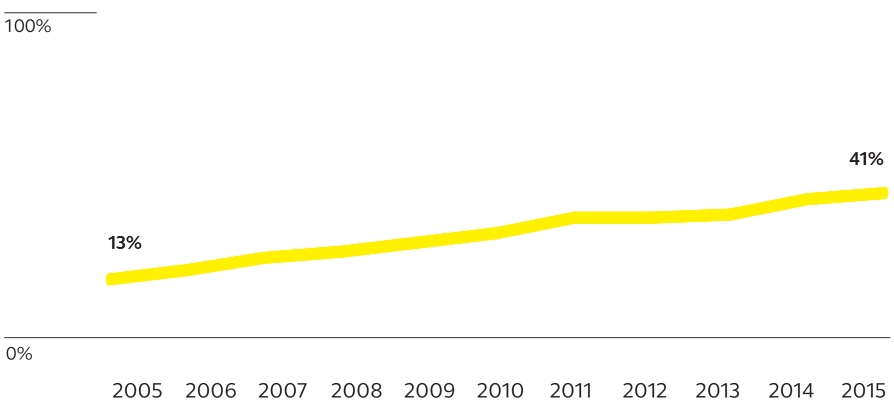
Averages tell only part of the story. As we dive deeper into these numbers, we find that there is pretty wide dispersion of the data. Even though a very high percentage of people under age 30 invest in TDFs, they collectively represent less than 20% of all TDF users.

This is attributable to the fact that those in their 20s participate in the plan at lower levels than other age groups. Nearly half of all actively employed participants who invest in TDFs have fewer than five years of service.

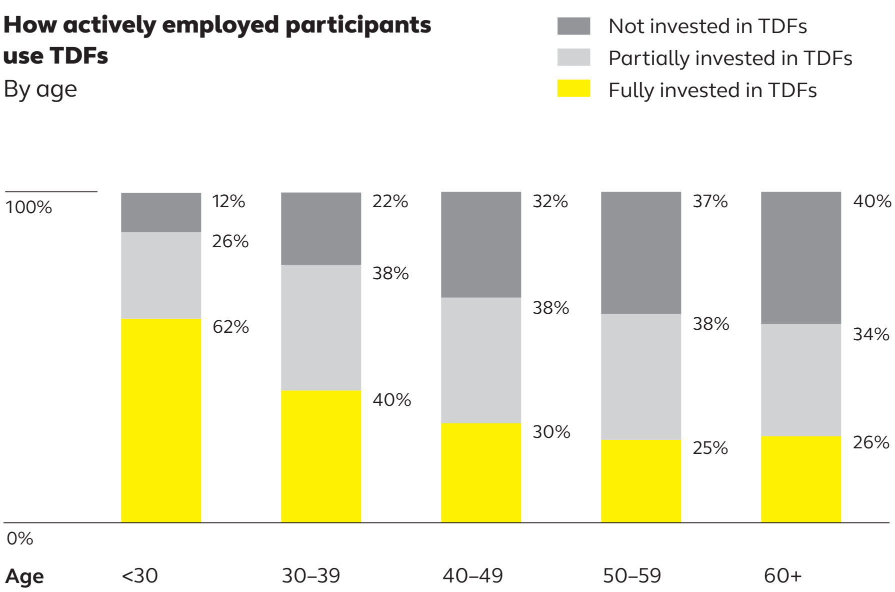
Percentage of balances invested in TDFs



Percentage of new contributions to TDFs



How actively employed participants use TDFs
By age



Target date funds are far from the majority of plan assets

Despite the fact that more than 70% of plan participants invest in TDFs, the asset class represents less than one-quarter of all the dollars in DC plans. At the beginning of 2016, only 23% of all money in DC plans was in TDFs. Even so, this is sizable growth from 6% a decade ago—and TDFs are now the largest asset class in many DC plans, largely fueled by the vast majority of new contributions allocated to them.

Why the disconnect? If so many people are using TDFs and TDFs are receiving more contributions than any other asset class, shouldn't they represent a larger proportion of the balances?

The difference can be attributed to two primary factors: First, many people allocate only a fraction of their balances to TDFs. Second, those who use TDFs tend to have smaller balances than those who do not use them.

Half of TDF users also invest in another asset class

Part of the appeal of target date funds is that they are designed to be an all-in investment. However, fewer individuals use TDFs as their sole investment than use TDFs in conjunction with other funds—49.7% compared to 50.3%.

Some of this behavior is the result of a lack of understanding. When employees were asked about the features of TDFs, only 9% correctly answered that a TDF is designed so that investors need to invest in one fund instead of several funds.[2]

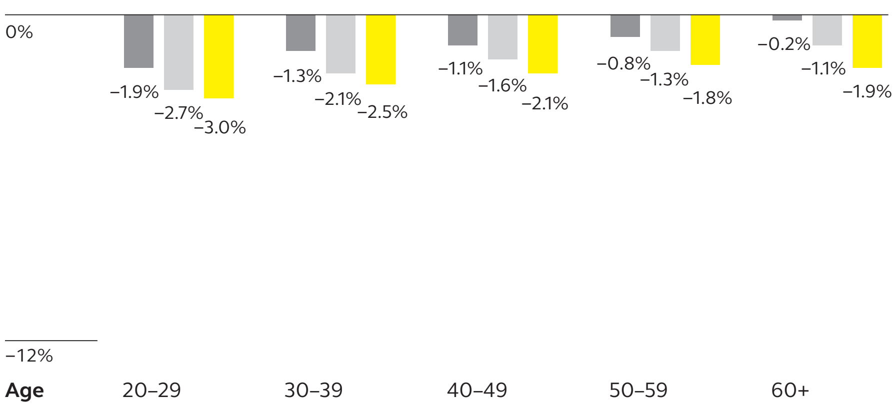
High partial TDF use could also be intentional. Target date funds inherently assume that all people of a similar age should be invested the same way. But heterogeneity exists.

Consider two 50-year-old participants: One has a large grandfathered DB plan benefit, a child who has finished college and a house that's paid off. The other is not eligible for a DB plan, and has children just starting college plus significant mortgage payments. Most would agree that these two employees should have different investment portfolios, but TDFs treat them the same way. Perhaps unsurprisingly, as age increases the percentage of participants who use TDFs as their entire portfolio *decreases*.

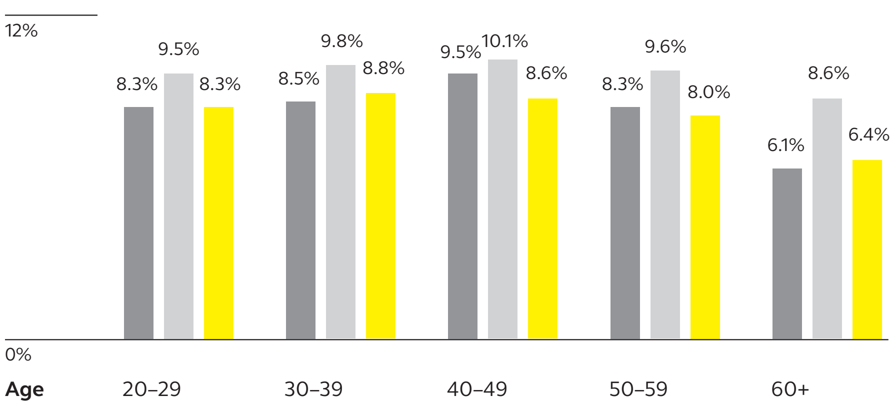
Rates of return for DC participants
by age and TDF usage

Not invested in TDFs
Partially invested in TDFs
Fully invested in TDFs

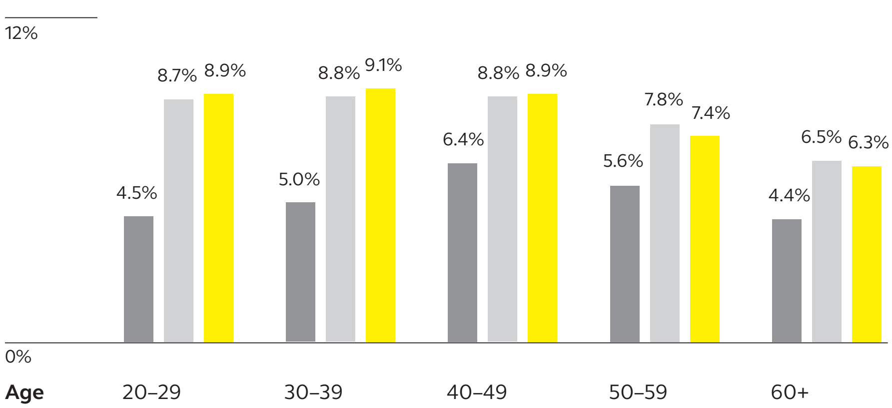
Median **2015** rates of return



Median **3-year annualized** rates of return



Median **5-year annualized** rates of return



If participants want to allocate their assets differently from the TDF's established allocation for their age, they must divert part of their balance away from the TDF. On average, partial TDF users have 33% of their balances in TDFs. Some of these participants add equities to their portfolios, some add fixed income instruments, and still others fold in employer stock.

Over the last several years, we have seen market cycles favor different participant view-points on TDFs. In 2015, when markets generally posted negative returns, those without TDFs outperformed those who used them. However, over longer time horizons, participants with TDFs beat those who did not use them.

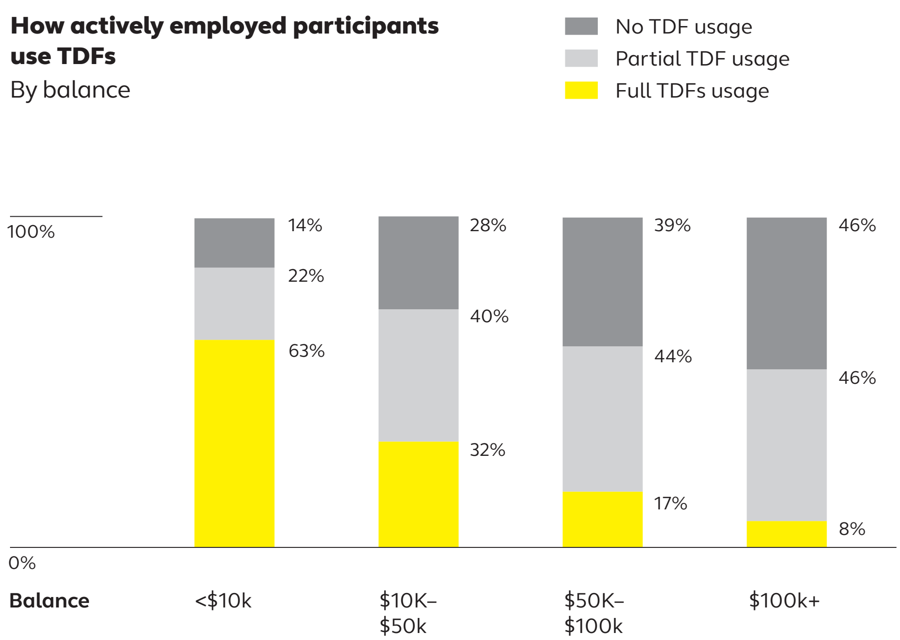
Demographic differences among plan participants
by TDF usage

	Not invested in TDFs	Partially invested in TDFs	Fully invested in TDFs
Percentage of population	**29%**	**36%**	**35%**
Average age	**48**	**45**	**40**
Average tenure (years)	**14**	**19**	**6**
Average compensation	**$62,000**	**$64,000**	**$46,000**
Percentage male	**57%**	**55%**	**45%**
Average balance	**$137,000**	**$111,000**	**$26,000**
Percentage with balance <$10,000	**17%**	**22%**	**62%**
Percentage with balance >$100,000	**37%**	**30%**	**6%**
Average percentage of balance in TDF	**0%**	**33%**	**100%**

Fully invested target date fund users tend to have low balances

Participants who are fully invested in TDFs have an average plan balance of $25,565, substantially less than the $111,938 average for participants who are partially invested in TDFs and the $136,704 average for participants who do not use TDFs at all. On average, full TDF users tend to be younger with shorter tenure and lower pay.

How actively employed participants use TDFs
By balance



CASE STUDY

Do participants choose the "correct" TDF?

Inherently and by definition, target date funds are designed to provide the optimal portfolio for a set investment horizon. For many within retirement plans, this time frame should correspond to retirement age—often age 65. Increasingly, plan sponsors are looking to see if participants are using the TDF that corresponds to their retirement age.

For this case study of one particular company, the chart below shows the specific vintage of TDF its actively employed participants are using. Each row is dedicated to individuals within a five-year age band and each column is the TDF maturity. The number in each cell is the percentage of people in the age cohort who are using the TDF fund. For example, the cell in the bottom left corner shows that among actively employed TDF users who are over age 68, 77% are primarily invested in an income fund.

The yellow cells correspond to the TDF maturity date that best corresponds to age 65. The dark gray cells are those who are within five years of age 65, recognizing that some people may have retirement ages that are slightly earlier or later than 65. The rest of the cells are shaded light gray and indicate a mismatch between the TDF vintage and age group.

As shown in this chart, the bulk of the participants are using the "correct" TDF or one with a maturity date that is very close to the "correct" one—the overall percentages were 68% in the yellow category, 22% in the dark gray, and 10% in the light gray.

This chart also shows that when many participants pick the "wrong" TDF, they tend to move very conservatively and choose the income fund. This could be intentional on the part of those participants or it may show a lack of understanding about TDFs.

According to Alight Solutions' *2016 Financial Mindset® Study*, 58% of workers said that they "don't know anything about target date funds."

Target date fund type/maturity

Age	Income	2015	2020	2025	2030	2035	2040	2045	2050	2055
22 and younger	0%	0%	1%	1%	1%	1%	1%	2%	27%	67%
23–27	2%	1%	1%	1%	1%	1%	1%	2%	58%	32%
28–32	2%	1%	1%	1%	1%	1%	1%	3%	86%	4%
33–37	3%	1%	1%	1%	2%	2%	4%	69%	17%	0%
38–42	3%	1%	2%	2%	3%	4%	67%	16%	2%	0%
43–47	4%	1%	1%	2%	4%	70%	15%	1%	1%	0%
48–52	3%	1%	2%	3%	67%	18%	2%	1%	1%	0%
53–57	4%	2%	5%	64%	19%	2%	2%	0%	2%	0%
58–62	6%	5%	63%	20%	2%	1%	2%	1%	1%	0%
63–67	6%	55%	27%	3%	3%	1%	1%	1%	1%	1%
68 and older	77%	16%	3%	1%	0%	0%	1%	1%	0%	0%

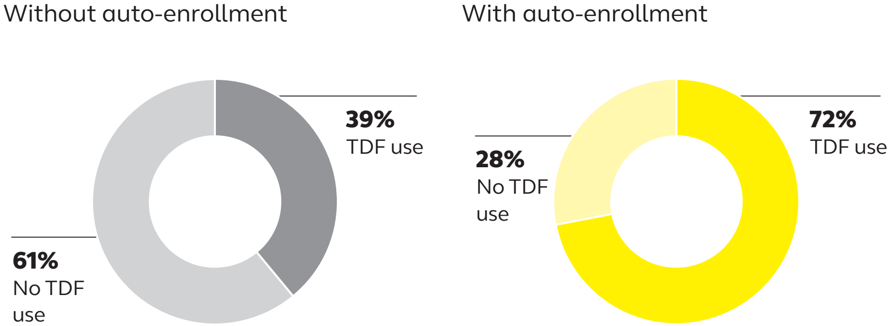
TDF maturity date best corresponds to age 65

Within five years of age 65, recognizing that some people may have retirement ages that are slightly earlier or later than 65

Mismatch between the TDF vintage and age group

Overall percentages
When we look at participants overall, 68% are in a TDF with a maturity date that best corresponds to age 65 (yellow), 22% have a maturity date within five years of 65 (dark gray), and 10% are mismatched (light gray).

TDF usage among plans



Demographic differences among TDF users

By enrollment method

	TDF users not subject to automatic enrollment in TDFs	TDF users subject to automatic enrollment and default investment in TDFs
Average plan balance	$78,696	$50,923
Percentage male	48.5%	51.5%
Average age	44.7	39.5
Average tenure (years)	10.8	5.7
Average salary	$53,204	$56,013
Average asset allocation to TDFs	67%	78%

The impact of automatic enrollment on TDF usage

Once the Pension Protection Act of 2006 paved the way for automatic enrollment and listed TDFs as a Qualified Default Investment Alternative, automatic enrollment and TDFs became linked. It would be difficult to discuss TDFs without acknowledging the impact automatic enrollment has had on these funds.

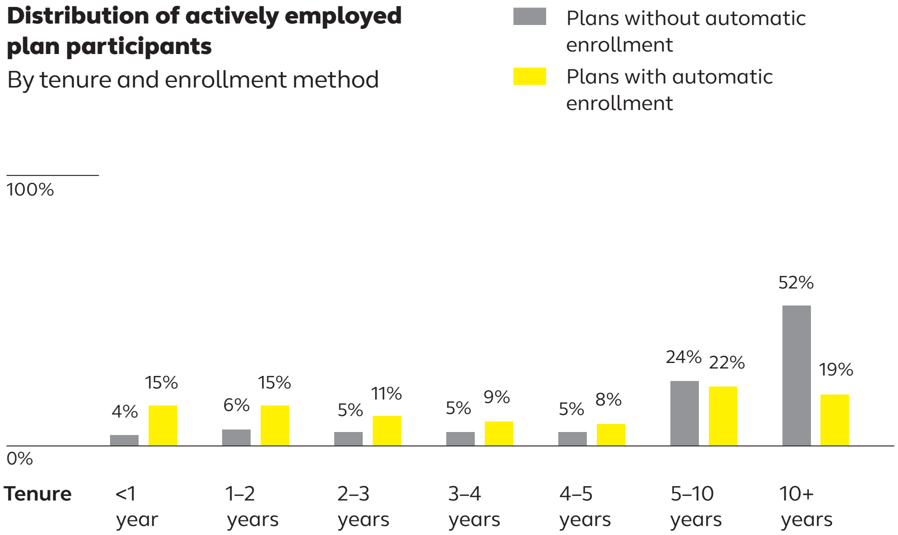
According to Alight Solutions' *2015 Trends & Experience in Defined Contribution Plans* survey, 58% of plan sponsors automatically enroll newly eligible participants in the plan. Among these employers, 81% use TDFs as their default investment option. Because automatic enrollment increases plan participation, participants who are subject to automatic enrollment are much more likely to use TDFs than participants who actively enroll.

Do people who are defaulted into TDFs behave the same way as people who actively enroll in TDFs? To answer that question, we can look at two data points: the average allocation to TDFs and the percentage of TDF users who are fully invested in TDFs.

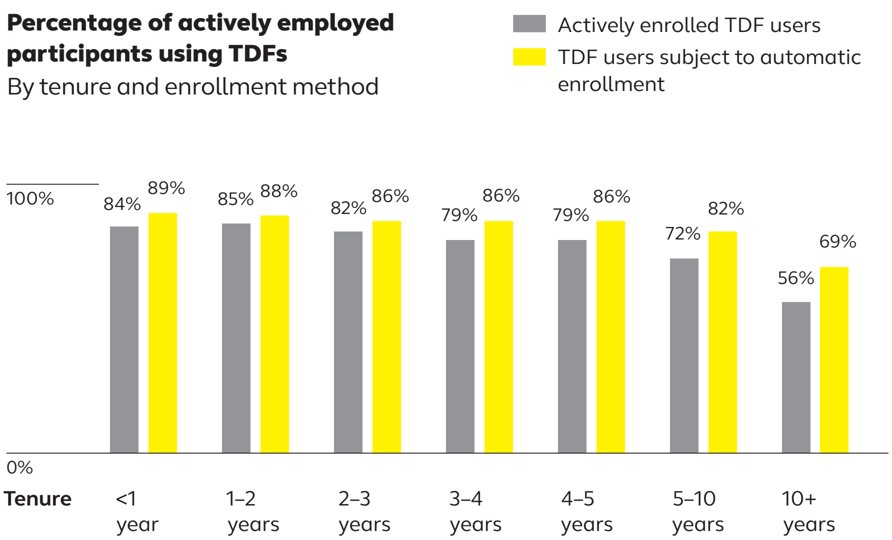
On average, individuals who are automatically enrolled in TDFs allocate more of their balances to TDFs than participants who choose TDFs of their own accord (78% versus 67%). However, compared to actively enrolled TDF users, participants who are defaulted into TDFs have lower average plan balances and are younger. Most importantly, automatically enrolled TDF users have an average tenure that is roughly half that of actively enrolled TDF users, and this skews the numbers for overall average use.

When we segment the different groups by tenure, the differences in TDF behavior are diminished. Regardless of how TDF users enter the plan, as tenure increases, TDF use decreases.

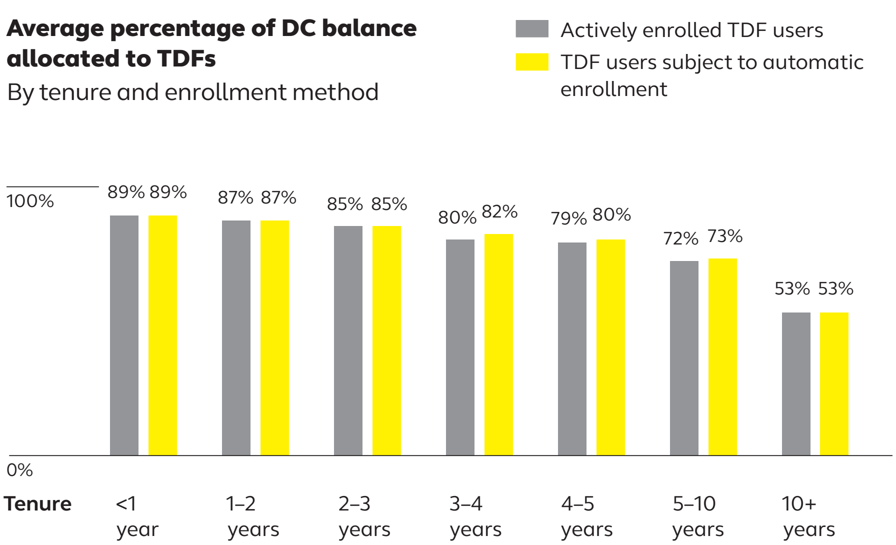
Distribution of actively employed plan participants
By tenure and enrollment method



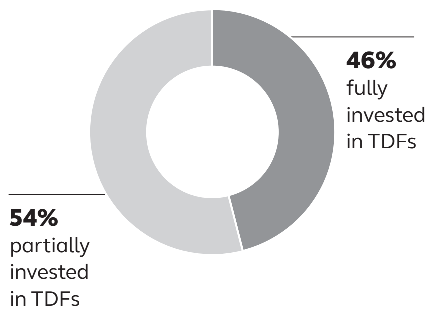
Percentage of actively employed participants using TDFs
By tenure and enrollment method



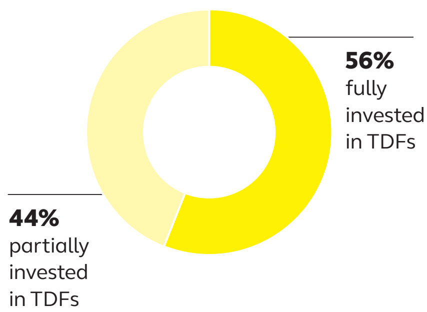
Average percentage of DC balance allocated to TDFs
By tenure and enrollment method



Actively enrolled TDF users

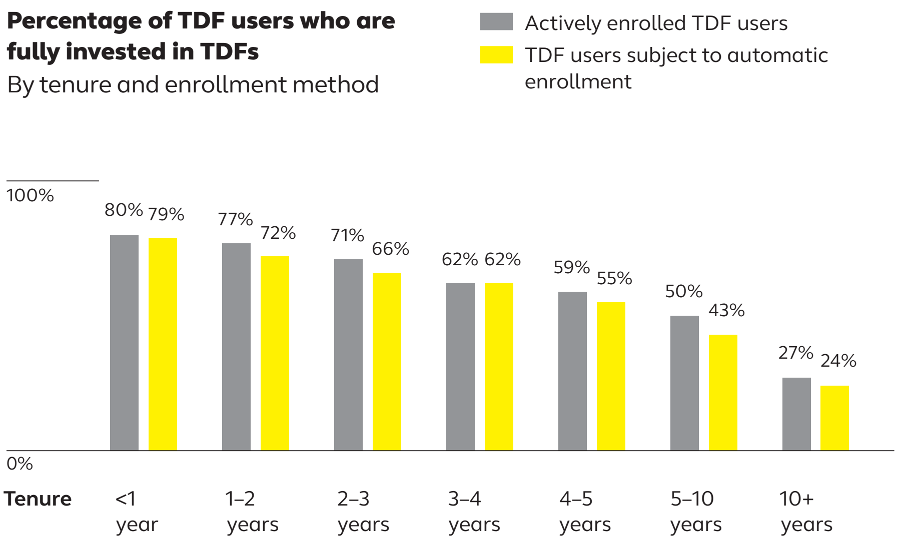


Automatically enrolled TDF users



Percentage of TDF users who are fully invested in TDFs

By tenure and enrollment method

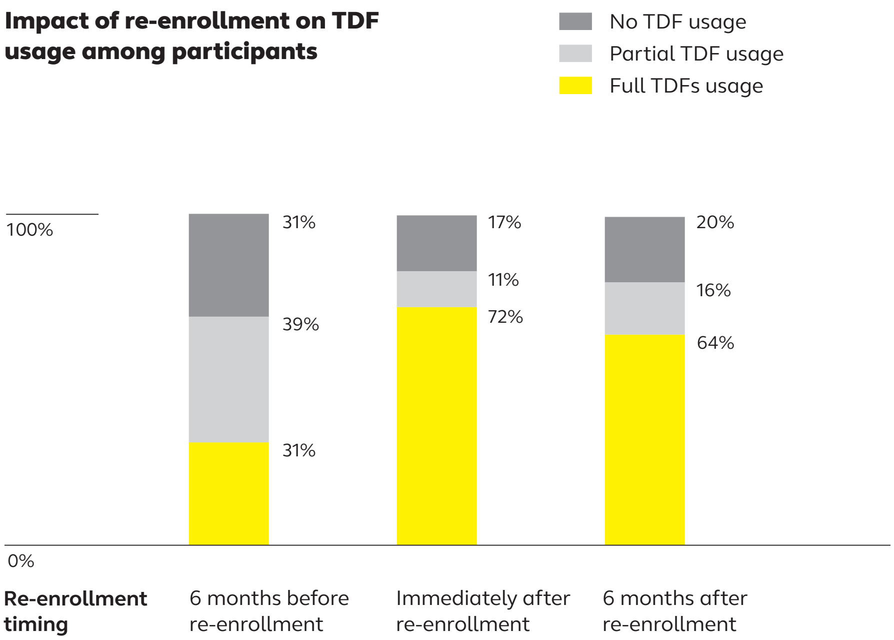


What about full versus partial usage?

Do people who choose to invest in TDFs utilize them more appropriately than people who are defaulted into them? Overall, a higher percentage of automatically enrolled TDF users than actively enrolled TDF users invest their entire portfolio in TDFs (56% versus 46%). However, as with TDF usage, there is little difference between the two groups if we isolate them by service.

The bar chart at left shows that the differences between automatically enrolled TDF users and actively enrolled TDF users are more a function of their length of service than their method of entering the plan.

Impact of re-enrollment on TDF usage among participants



CASE STUDY

What about re-enrollment?

Some plan sponsors have been considering plan re-enrollments in which individuals' accounts are mapped to the age-appropriate TDF at a specified date unless the participant opts out. According to Alight Solutions' *2015 Trends & Experience in Defined Contribution Plans*, 7% of plan sponsors had recently re-enrolled participants and another 3% were planning to do so.

Based on data from case studies, plan sponsors that go through a re-enrollment exercise can expect to see an increase in the percentage of individuals who use TDFs. Moreover, the number of participants who are fully invested in TDFs will likely increase as well. However, plan sponsors should not expect all TDF users to fully invest in the funds, and the resulting spikes in TDF usage may not be long term.

The chart to the left shows data from a company that re-enrolled participants in a TDF. Data from six months before the re-enrollment showed that roughly 70% of participants had allocated some money to the TDFs, with most of these participants being partial TDF users. For this client, the impact of re-enrollment was profound: TDF usage increased, with the number of full TDF users more than doubling.

However, when we looked at data from six months after the re-enrollment, we found that some of the gains had retreated. Full TDF use dropped by 8 percentage points and partial TDF use grew. But overall, 80% of participants still had some money allocated to TDFs, with full TDF users outnumbering partial TDF users four to one.

Of course, plan sponsors should act carefully when carrying out a re-enrollment. Plan participants should not feel surprised by the event. They should receive ample communication about the process and be provided a long timeline until the event. Plan sponsors must also consider the impact on non-TDF plan investments that may see their asset sizes shrink.

Conclusion and next steps

During the past decade, target date funds have exploded onto the scene. More employers are offering them and more participants are using them. However, most of these individuals do not use the TDFs as the turnkey investment solution they are designed to be. Additionally, as tenure increases, TDF users are less likely to use TDFs, regardless of whether they were defaulted into them or actively chose them.

Part of the sub-optimal use of TDFs can be explained by the fact that TDFs are just one type of investment tool. While they can be very effective for people who have more basic financial needs and limited outside investments, TDFs become more difficult to use for people who have more specialized investment goals or have multiple retirement accounts.

Armed with this knowledge, plan sponsors can ask themselves the following questions:

- How does the target date fund usage in your plan compare to the averages shown here?
- What communications should be sent to participants to help improve their understanding of TDFs?
- Would the plan benefit from re-enrolling participants into TDFs?
- What other tools can be added to the plan to provide professional investment help to participants, yet also address their unique investment situations?

Sources

1 Alight Solutions' *2015 Trends & Experience in Defined Contribution Plans*.

2 Alight Solutions' *2016 Financial Mindset® Study*.

About Alight Solutions

As the leading provider of benefits administration and cloud-based HR and financial solutions, we enhance work and life through our service, technology and data. Our 22,000 colleagues across 14 global centers deliver an unrivaled consumer experience for our clients and their people. We are Alight. Reimagining how people and organizations thrive.

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