NATIXIS INVESTMENT MANAGERS | SOLUTIONS

The evolution of target date funds

By Christopher Sharpe, CFA®

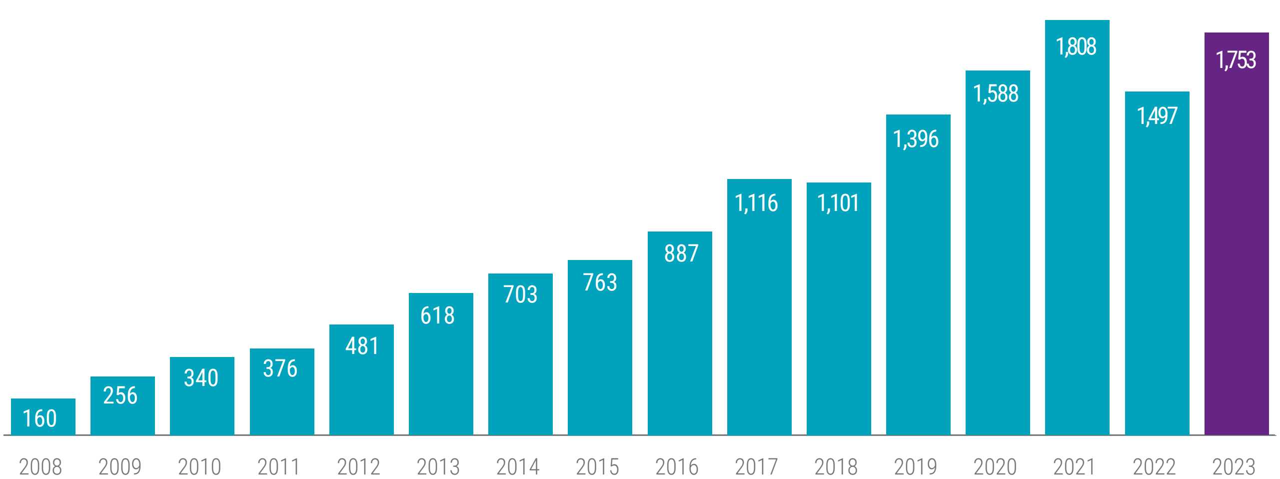
Executive summary

Since their creation in the mid-1990s, target date series have become a staple of retirement plan investing. More recently, hybrid funds that combine the benefits of active and passive investing have begun competing for assets in a space that tends to be dominated by indexing. Portfolio Manager Christopher Sharpe reviews the evolution of target date funds and outlines five key features associated with the Natixis Target Retirement Funds, which were launched in 2017.

Target date funds: A foundation of retirement plan investing

Since their creation in the mid-1990s, target date mutual funds have become a staple on retirement plan menus. Although growth and acceptance were slow at first, target date funds gained traction following the passage of the Pension Protection Act in 2006 and remain a popular investment choice (Figure 1).

FIGURE 1: Growth of assets in target date funds, $ billions



Source: ICI

Their intent has changed little over the years. Target date series are designed to simplify the investment process for employer-sponsored retirement plan participants by offering funds that align with a broad range of employee retirement timelines.

Target date funds are typically available in five-year increments, with year 2065 funds now available for the youngest participants. Target date funds offer plan participants the benefits of professional management, with asset allocations that evolve over time to become more conservative as the retirement target date draws closer. The trajectory of the asset allocation is determined by the funds' glide path, which may extend to the specified retirement year, or beyond it, depending on fund design.

As of year-end 2022, there were 60 million active 401(k) participants, and 59% of them were invested in target date funds.[1]

Key benefits for plan participants – and plan sponsors

Benefits associated with an age-based target date investment approach include:

- Simplified fund selection process that can help increase participation by employees who may not be familiar with basic investment principles.
- Broadly diversified, professionally managed, risk-appropriate portfolios tailored to a participant's age or retirement time horizon.
- Consistent, long-term investment process designed to address the broad objectives of retirement savers.

Thanks to this combination of benefits, target date series are well respected as a QDIA (qualified default investment alternative) for plan sponsors. Their age-appropriate investment strategies and broad diversification address the primary concerns associated with fiduciary responsibility.

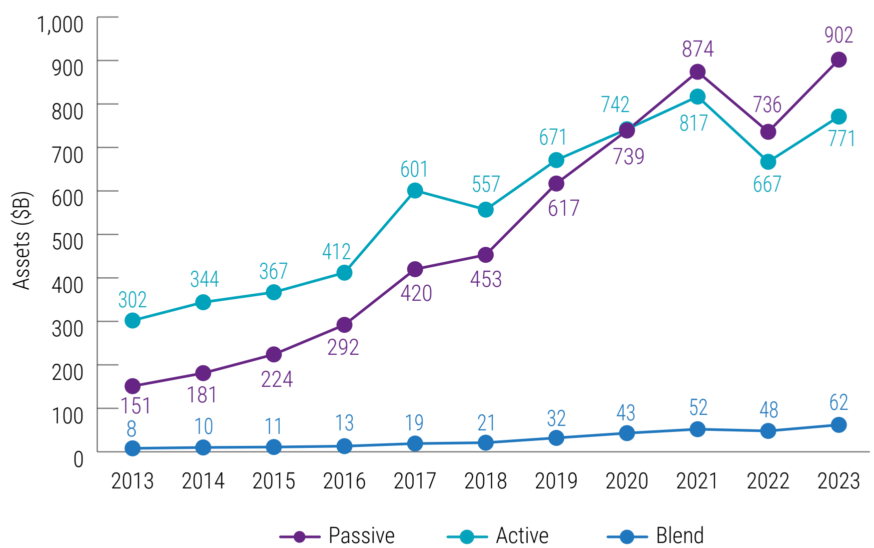
The evolution of a retirement plan staple

Unlike other investment options, target date funds are specifically designed to be used as part of a retirement savings program.. In return for selecting the appropriate fund vintage and making regular contributions, target date investors can rely on fund managers and the asset allocation glide path to rebalance assets as needed to pursue returns and manage risk.

Although target date funds have evolved over the years, they have stayed true to their original mandate: to provide retirement investors with a better path to a financially secure retirement. They differ fundamentally from funds that pursue a static investment objective and maintain an asset allocation strategy that doesn't reflect investors' changing needs over time.

The earliest target date families used actively managed mutual funds to gain asset class exposures, but that began to change in the years following the Global Financial Crisis (2007–2009). Growing acceptance of index funds during the long bull market of the 2010s – combined with heightened sensitivity to fees – resulted in faster growth for passive target date series (Figure 2). Passively managed series accounted for 52% of target date fund assets as of 12/31/23, compared to 44% for active management and 4% for blend.

FIGURE 2: Passive target date series outpace active and blend (12/31/23)



Source: ISS MI Simfund

Yet even with underlying assets held in passive investments, active management is still required to ensure that the funds rebalance regularly to manage risk and adhere to their glide path. More recently, hybrid target date funds that combine the benefits of active and passive investing strategies have begun competing for assets in the target date space.

A hybrid, multi-vehicle, multi-manager target date series

The Natixis Target Retirement Funds* were launched in 2017, using a combination of strategies designed to draw on the strengths of active and passive investment styles. Although built on a target date fund chassis, they offer five key differences from more traditional offerings.

> The Natixis Target Retirement Funds' hybrid strategy is not tethered exclusively to an active revenue stream or a passive, low-fee philosophy.

#1 Hybrid active/passive approach

As technology continues to increase the efficiency of the capital markets, restricting a long-term multi-asset investment like a target date fund to an all-active or all-passive strategy shortchanges retirement savers. There are distinct benefits, risks and opportunities associated with both investment approaches.

- **Passive strategies** can be counted on to track the performance of an index – good or bad – with modest guaranteed underperformance attributable to fees.
- **Active strategies** bring the potential to outperform an index – but must overcome their higher fees in the process.

The Natixis Target Retirement Funds employ a hybrid strategy that is not tethered exclusively to an active revenue stream or a passive, low-fee philosophy. This flexibility offers the largest opportunity set across the broad range of equity and fixed income asset classes.

#2 Combination of asset and vehicle types in a single multi-asset fund

Target date funds differ from traditional mutual funds and separately managed accounts (SMAs) because they are designed to evolve over time to accommodate the changing needs of investors saving for and entering into retirement. Arguably, the ability to capitalize on opportunities and manage risk takes on even greater importance for target date fund investors who are saving for retirement.

For this reason, constructing a target date strategy is different from creating a fund lineup for a defined contribution plan where plan participants can choose their own offerings. Building a successful multi-fund/multi-asset-class (MF/MAC) portfolio requires all the funds and strategies to work together across the investment horizon and throughout changing market cycles. Addressing this mandate effectively requires a strategic and evolving blend of assets.

> The combination of mutual funds and separately managed segments provides flexibility to customize the portfolio so all the puzzle pieces fit together, supporting portfolio design and construction.

The Natixis Target Retirement Funds allocate their assets among investments in strategies and underlying funds managed by the adviser or affiliated advisers that invest directly in securities. This allows customization on many levels, including:

- Concentration of holdings
- Style diversification: growth/value
- Benchmark aware vs. benchmark agnostic
- ESG awareness/thematic investing
- Factor tilts: growth, dividend-paying equities, etc.

*Effective July 1, 2024, the name of the Natixis Sustainable Future Funds changed to Natixis Target Retirement Funds. Each fund's investment goals and principal investment strategies remain the same; fund name changes are in sequential 5-year periods from 2015 to 2065.

Using a combination of mutual funds and separately managed segments provides the flexibility to customize the portfolio across multiple asset classes so all the puzzle pieces fit together, supporting portfolio design and construction.

#3 Use of multiple managers supports strategic diversification

Strategic, qualitative diversification is essential for pursuing alpha -- the ability to beat the market -- and managing risk across target date portfolios. Access to multiple asset managers supports meaningful diversification that reduces the chance of investments being managed in the same way. Passively managed investments provide baseline beta exposure to market index returns, while active asset managers bring alpha potential associated with their specific strategies.

However, it is important to recognize that active managers tend to be guided by pervasive investment philosophies, often based on the historical success of company founders or star managers. Although this is desirable for a robust, repeatable investment process, multiple expressions of the same investment process do not provide effective diversification.

For these reasons, the Natixis Target Retirement Funds use a range of different managers to support diversification and minimize the downside of "groupthink." Effective diversification requires bringing together managers that operate on different axes or with different philosophies, such as pairing a fundamental manager with a quant practitioner or a bottom-up stock picker with a top-down macro manager.

Strategic, qualitative diversification* is essential for pursuing alpha potential and managing risk across target date portfolios.

For example, if the Russell 3000 represents the broad US equity market, the goal is to bring together a group of managers who zig and zag differently in the same space to build the desired allocation to US equities. The combination of their different styles, economic outlooks and philosophies can generate differentiated performance across market cycles. Think about all the different ways a square can be divided into four parts (Figure 3). The Natixis Target Retirement Funds seek out fund managers who bring their own unique lens to security selection.

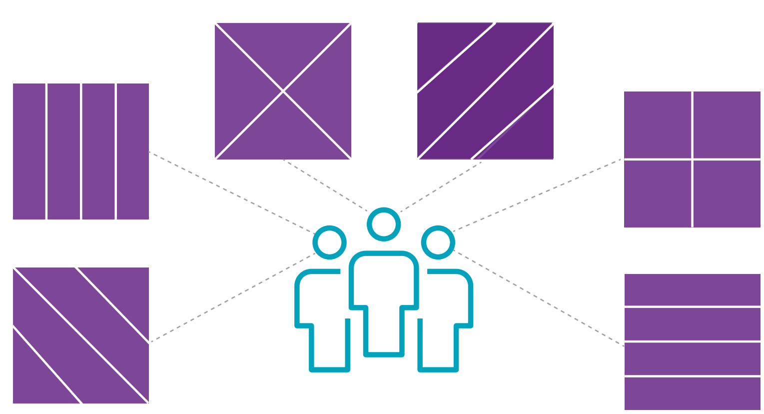
#4 Diversification due diligence – more isn't necessarily better

So how can a portfolio manager ensure meaningful and constructive diversification that creates opportunities for alpha and also manages risk? We can monitor evidence of manager diversification by analyzing specific portfolio characteristics and the path they follow over time and across changing market cycles. A partial list includes:

- Tracking error
- Active share
- Benchmark aware vs. benchmark agnostic
- Name count/portfolio concentration
- Sector/market capitalization exposure for stocks
- Duration/quality metrics for bonds

Even with this relatively small number of variables, it's easy to see there are infinite possibilities associated with combining multidimensional assets. Bringing the investments together most effectively is the challenge. Suppose you combine three active US equity funds and they have an aggregate tracking error close to zero. Yes, that's diversification – but you'd be better off buying the index.

FIGURE 3: Multiple managers help ensure diverse points of view



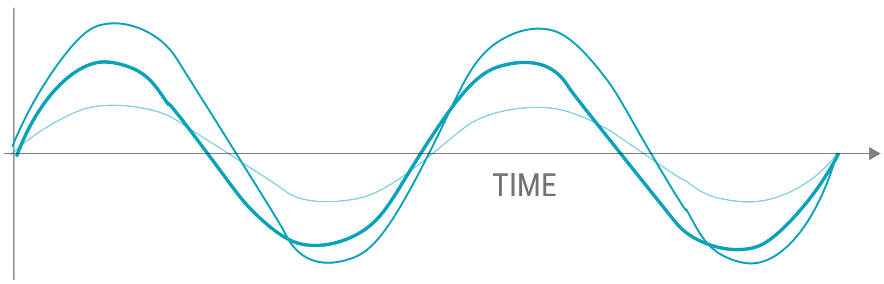
*Diversification does not guarantee a profit or protect against a loss.

Tracking error isn't necessarily the best measure, but it provides a good example. It is most valuable for evaluating a passive investment where minimal variance from the index is the goal. Otherwise, we think of tracking error as the radius of gyration around a point moving through time. We know that we don't want the tracking error to be close to zero – and then we can examine the other characteristics.

It can be helpful to think about each strategy as a sine wave moving through time around a horizontal line that represents alpha (Figure 4). The goal is to combine the strategies in a thoughtful way that smooths out the extremes but doesn't completely offset the variances.

We monitor evidence of manager diversification by analyzing specific portfolio characteristics and the path they follow over time and across changing market cycles.

FIGURE 4: Encourage variation, but offset the extremes



- If all the strategies line up, they end up amplifying the same wave – and the resulting resonance could lead to extreme highs and lows, which runs counter to the desired result.
- Conversely, if every movement is completely offset, it's like noise-canceling headphones. The end result is a very expensive fund that performs like the broad index.

In the Natixis Target Retirement Funds, we use a mix of diverse investment styles with low and high tracking error. We bring them together to flatten that line as much as possible but keep it above the horizontal axis: That's our alpha.

#5 Sustainability and risk management

And finally, just as approaches to pursuing alpha can differ, so do approaches to managing risk. One key to building a successful target date series is to identify the full range of risks to the investment strategy. For this reason, awareness of ESG (environmental, social, governance) considerations is an important component of our risk management strategy.

We believe that ESG factors can have a material impact on financial performance, particularly over a long-term investment horizon.

We believe that ESG factors can have a material impact on financial performance over an investment horizon, particularly over the long term. According to the Department of Labor's final rule titled *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, "While investment options should make financial considerations the primary concern, fiduciaries may consider participant preferences when selecting investment options."

For plan sponsors, a focus on ESG considerations is consistent with research showing that retirement plan participants see strong financial reasons for investing this way. Survey data shows that 83% of participants believe companies that focus on sustainable business practices present significant growth opportunities for their investments.[2]

Similarly, 88% of Millennials and 72% of Gen X workers surveyed say they would be more likely to increase contributions (or start participating) if they could invest in companies with good environmental, social and ethical practices.[2]

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94% of Millennials surveyed say ESG factors can affect investment performance.[2]

THE EVOLUTION OF TARGET DATE FUNDS

Over the years, target date funds have earned the respect of plan sponsors looking to provide well-diversified, professionally managed, risk-appropriate investment options for plan participants. Looking ahead, the bigger challenge may be to find new ways to motivate employees to fund their retirement accounts more aggressively, to help them build a more sustainable financial future.

To learn more, contact us:
Visit: im.natixis.com Call: 800-862-4863

ABOUT THE AUTHOR

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Christopher Sharpe helps oversee the firm's model portfolios and is the Lead Portfolio Manager for the Natixis Target Retirement Funds. Prior to joining the firm, he spent 15 years at Fidelity Investments, managing over $225 billion in multi-asset-class mutual funds and institutional accounts.

As lead portfolio manager for the Fidelity Freedom Funds, Christopher was responsible for portfolio strategy, design, implementation and due diligence. He also served previously as an investment policy officer at John Hancock, managing the investment and asset/liability strategies backing the insurance company's deferred annuities, and as an investment actuary and retirement plan design consultant at Mercer Consulting.

Christopher holds a bachelor's degree in applied mathematics from Brown University. He is a CFA® charterholder and a Fellow of the Society of Actuaries.

Before investing, consider the fund's investment objectives, risks, charges, and expenses. Visit im.natixis.com or call 800-862-4863 for a prospectus or a summary prospectus containing this and other information. Read it carefully.

Natixis Target Retirement Funds important information:

The Funds are designed for investors who will be age 65 around the year indicated in each Fund's name. When choosing a Fund, investors who anticipate retiring significantly earlier or later than age 65 may want to select a Fund closer to their anticipated retirement year. Besides age, there may be other considerations relevant to fund selection, including personal circumstances, risk tolerance and specific investment goals.

Each fund's asset allocation becomes increasingly conservative as it approaches the target date and beyond. Allocations may deviate plus or minus 10% from their targeted percentages.

Investments in the Funds are subject to the risks of the underlying funds and separately managed segments. Principal invested is not guaranteed against losses. It is possible to lose money by investing in the Funds, including at and after the Funds' target date.

Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. Use of overlay management and tax management strategies does not guarantee a profit or protect against a loss in an investor's portfolio.

Equity securities are volatile and can decline significantly in response to broad market and economic conditions. • **Fixed income securities** may carry one or more of the following risks: credit, interest rate (as interest rates rise, bond prices usually fall), inflation and liquidity. • **Foreign and emerging market securities** may be subject to greater political, economic, environmental, credit, currency and information risks. **Foreign securities** may be subject to higher volatility than US securities, due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets. • **Mortgage-related and asset-backed securities** are subject to the risks of the mortgages and assets underlying the securities. Other related risks include prepayment risk, which is the risk that the securities may be prepaid, potentially resulting in the reinvestment of the prepaid amounts into securities with lower yields. • **Multi-manager funds** may be managed by several subadvisors using different styles that may not always complement each other. This could adversely affect performance and may lead to higher fund expenses. • **ESG investment risks:** The Fund's ESG investment approach could cause the Fund to perform differently compared to funds that do not have such an approach or compared to the market as a whole. The Fund's application of ESG-related considerations may affect the Fund's exposure to certain issuers, industries, sectors, style factors or other characteristics and may impact the relative performance of the Fund – positively or negatively – depending on the relative performance of such investments. • **Inflation-protected securities** move with the rate of inflation and carry the risk that in deflationary conditions (when inflation is negative) the value of the bond may decrease.

NATIXIS INVESTMENT MANAGERS SOLUTIONS

Natixis Investment Managers Solutions provides design, development and execution of portfolio strategies tailored to specific investment objectives and unique portfolio constraints. Our Multi-Asset Portfolios include core, completion and thematic model portfolios, multi-asset mandate capabilities, and target date funds.

This material is intended for informational purposes only, does not constitute investment advice and should not be construed as a recommendation for investment action. The information provided does not take into account the investment objectives, risk tolerance, restrictions, liquidity needs or other characteristics of any one particular investor.

1 Source: Investment Company Institute 2023 Fact Book

2 Natixis Investment Managers, Survey of US Defined Contribution Plan Participants conducted by CoreData Research, January and February 2023. Survey included 736 US workers, 587 being plan participants and 149 being non-participants. Of the 736 respondents, 362 were Millennials (age 27–42), 166 were Gen X (age 43–58) and 208 were Baby Boomers (age 59 and above).

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