Vanguard Target Retirement Funds go all-index

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Vanguard Target Retirement Funds have always been largely index-driven. However, when Vanguard made several changes to its Target Retirement Funds early in 2013, the result was a product set that now incorporates a fully indexed approach.

Among the changes was the removal of the cash allocation, a money market holding, from the Target Retirement Funds. Vanguard also replaced an actively managed broad-market Treasury Inflation-Protected Securities (TIPS) fund with the new Vanguard Short-Term Inflation-Protected Securities Index Fund. Lastly, Vanguard diversified fixed income exposure with the addition of Vanguard Total International Bond Index Fund. The cash and broad-market TIPS allocations were the only ones that prevented the Target Retirement Funds from being 100% indexed. According to Matt Brancato, Target Retirement Fund manager in Vanguard Portfolio Review Department, 100% indexing can be a boon for sponsors and participants.

"Being all-index can offer benefits from a fiduciary standpoint," Mr. Brancato said. He pointed out that low-cost index funds, which attempt to track a specific market index and allow investors to keep more of their returns, are built on robust academic theory and practical foundations of outperformance. By delivering the market's return, index funds avoid exposure to specific securities or sectors. At any given point in time, some active managers will outperform and some will underperform, but in aggregate, active management should underperform indexing by the cost of the active strategy. (Please note that most index funds underperform their benchmarks because of fees.)

For individuals who choose to take on the additional risk, active management may be appropriate. However, for target-date funds (TDFs) that plan sponsors use as a qualified default investment alternative (QDIA), "it could make a lot of sense to strip out the risks associated with active management," Mr. Brancato said.

Investments in target-date funds and Target Retirement Funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in the Target Retirement Fund is not guaranteed at any time, including on or after the target date.

The reasoning behind 100% indexing

When Vanguard introduced its Target Retirement Funds in 2003, the choice was to develop mostly indexed TDFs even though many in the industry were offering active TDFs. The benefit of choosing passive management was highlighted after passage of the Pension Protection Act of 2006 (PPA), which allowed TDFs as a QDIA. Removing as much risk as possible from funds into which many retirement plan participants are defaulted can make sense from both fiduciary and investing perspectives.

But while our Target Retirement Funds have always been largely indexed investments, the funds' TIPS—a Treasury security designed to protect investors from the negative effects of inflation—were an active component until the recent change to indexed short-term TIPS.

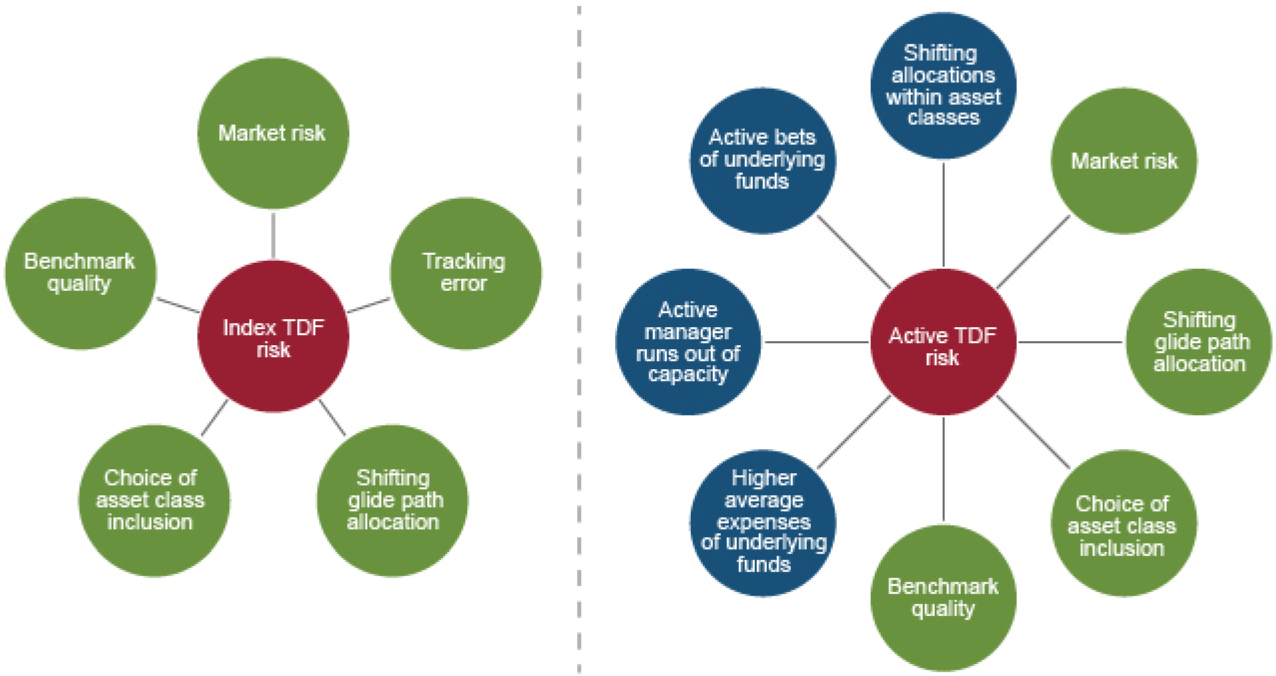
"Short-term TIPS are more highly correlated with inflation than investments with broad-market TIPS exposure, and have lower volatility," Mr. Brancato said. TIPS may provide a better inflation hedge than other investment types because the security's value is periodically adjusted for inflation, thus offering a fixed real rate of return regardless of the level of inflation. "When you look at the numbers, short-term TIPS are the best inflation hedge there is. No matter what you compare it with—broad-market TIPS, commodities, gold, REITs (real estate investment trusts)—short-term TIPS exposure has provided that inflation hedge more effectively than other asset classes."

In addition to broad diversification, indexing generally offers lower costs, market-like returns, and transparency. Active management, on the other hand, offers the potential for outperformance, but it may also involve higher costs and additional risks. These risks include:

- **Manager risk**. Active management can add value if delivered effectively. Of course, the flip side is that it may not be effective and the investment underperforms.
- **Capacity risk**. Unique to active management, capacity risk is the risk of reaching the limit of how many dollars can go into the fund—a particularly unappealing scenario for a default fund in a plan lineup.
- **Risk of dispersed returns**. Yes, active has the potential to outperform an index—but if it underperforms the benchmark, will participants react by pulling assets from the fund? Will they then miss out on returns if the fund rebounds? An indexed Target Retirement Fund as a plan's default investment makes this a nonissue, because it simply seeks to track the index.
- **Sector risk and security risk**. Active managers can fill their portfolios by overweighting or underweighting sectors, or by buying and selling certain stocks. Hence, there's the risk that they select the sectors or the securities that underperform the market.

Mr. Brancato pointed out another potential indexing advantage: The fact that "index" refers to a market-cap-weighted index, which is a sophisticated, diversified portfolio solution that evaluates every piece of information in the marketplace through market prices to weight each of the sectors within the fund on a relative basis. In an actively managed investment, on the other hand, managers may base their sector and security choices on a subset of the total information available in the marketplace.

Need for fiduciary oversight increases with active TDFs



Cost versus performance

In addition to offering fewer risks, index funds can provide a cost advantage. Over the long term, index funds have shown the ability to perform favorably against their active counterparts—and lower costs has been a major reason why.

"Most TDFs are active," Mr. Brancato said, "and the average cost of active TDFs is higher than Vanguard Target Retirement Funds' cost of between 16 and 18 basis points. The cost difference can have a big impact for a retirement portfolio being built over a 30- or 40-year time span."

While actively managed TDFs may have more risk than Vanguard's all-indexed Target Retirement Funds, is now perhaps the time to take on that risk? After all, many in the industry cite the low interest rate environment as a rationale for employing active bond strategies. But according to Mr. Brancato, sponsors haven't been switching to actively managed TDFs—and he thinks they're making the right move by sticking to index funds. Stripping out active risk for TDFs used as a QDIA is resonating with plan sponsors.

"Vanguard is seeing record cash flows into our Target Retirement Funds—and, while there are others that incorporate indexing, we're one of only three target-date options out there that uses a fully market-cap-weighted approach within asset classes and does not incorporate tactical asset allocation," Mr. Brancato said.

When considering TDFs from a fiduciary perspective, it's important to remember the distinctions between defined contribution (DC) plans and defined benefit (DB) plans. With DC plans, sponsors are making choices with potential investment outcomes that will ultimately be borne by the participant. In this context, a transparent and straightforward approach such as in the all-index Target Retirement Funds can work well for both sponsors and participants. Active and tactical strategies represent additional layers of fiduciary oversight for plan sponsors that can be challenging to explain to participants, particularly when they underperform the broad market.

"A major reason for plan sponsors to consider Vanguard Target Retirement Funds, with their 100% indexing, is the fiduciary risk that sponsors have," Mr. Brancato said. "Plan sponsors need to determine whether they're comfortable defaulting participants into an option that has active manager risk, or whether they'd rather default participants into an option that's stripping out as many risks as possible. We think that active management can have a place in a lineup—just not as a default option."

Notes:

- **An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.**
- All investing is subject to risk, including the possible loss of the money you invest. Past performance is not a guarantee of future results. Diversification does not ensure a profit or protect against a loss in a declining market.
- While U.S. Treasury or government agency securities provide substantial protection against credit risk, they do not protect investors against price changes due to changing interest rates.
- Funds that concentrate on a relatively narrow market sector face the risk of higher share-price volatility.
- The Total International Bond Index Fund is subject to currency risk, which is the chance that currency hedging transactions may not perfectly offset the fund's foreign currency exposures and may eliminate any chance for a fund to benefit from favorable fluctuations in those currencies. The fund will incur expenses to hedge its currency exposures.