

# A powerful combination: Target-date funds and managed accounts

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For investors seeking customized professional advice with their investments, target-date funds or managed accounts can often fit the bill. For plan sponsors, though, the question shouldn't be "Well, which one?" but, rather, "How about both?"

Defined contribution (DC) plans are an increasingly important source of income for retirees. As a result of the growing prominence of DC plans, plan sponsors and providers are scrutinizing these plans to ensure that they accommodate participants' long-term needs. As a result, plans are being transformed by the widespread adoption of target-date funds (TDFs), often as the default fund, and by the use of managed accounts as a complementary strategy.

These strategies are expanding in response to the recognition that many participants might not have the skills, time, or inclination to create suitable portfolios on their own. With the emergence of professionally managed strategies like TDFs and managed accounts, participants can now delegate this task to a fund manager or a third-party advisor.

This article highlights Vanguard research on the beneficial impact that professionally managed allocations are having on DC plan participants and outlines the appropriate roles of TDFs and managed accounts. We emphasize that these are complementary options within a plan and that sponsors should consider offering both, rather than one or the other.

**The issue:** Many plan participants may be invested inappropriately for their age, risk-tolerance, or financial situation.

**The challenge:** Participants might not have the skills, time, or inclination to create a suitable retirement portfolio on their own.

**Vanguard conclusion:** Our research shows that adding professionally managed strategies like target-date funds and managed accounts to DC plans can be helpful. These strategies allow less engaged participants to delegate portfolio management to a fund manager or third-party advisor and can have positive effects on portfolios, including an age-related reduction of risk in asset allocation and more predictable return outcomes.

## TDFs: A cornerstone of DC plans

Since their emergence more than a decade ago, target-date funds (TDFs) have seen explosive growth in assets and popularity, and are quickly becoming a fundamental part of almost all DC plans. Developed as a key tool to help less-engaged participants make sensible portfolio choices, TDFs have also been designated as qualified default investment alternatives (QDIAs) in many DC plans, especially in those offering automatic enrollment.

Note: This article is adapted from a 2012 Vanguard research paper by the same authors and title; available at <http://institutional.vanguard.com/powerfulcombination>.

The ultimate investment goal of a TDF is to offer participants a prudently selected and well-diversified portfolio appropriate for saving for retirement. Vanguard believes that diversified exposure to broad asset classes is critical to achieving this objective, and that this approach will meet most participants' needs.

Vanguard also believes that a well-designed, strategic TDF should be implemented with primarily passive, cap-weighted index funds. Such a design should also offer appropriate asset allocation along the glide path, broad diversification within asset classes, and the advantage of low costs. In addition, a straightforward, index-focused approach makes these funds easy for participants to understand and for plan sponsors to evaluate. An index-based design is particularly suitable as a QDIA, as it helps to eliminate active risk exposures and to minimize fees, while offering the potential to improve performance over long periods.

### **Managed accounts: A complement to TDFs**

For sponsors seeking a program offering customized portfolios to meet the specific needs of individual participants, we believe a managed account advisory service is a sound complementary strategy to offering TDFs. In fact, it's the only way to truly customize an investment portfolio solution to participant demographics and other characteristics.

Under a managed account program, a plan sponsor selects a third-party advisor to provide independent investment advice to participants. Participants who enroll in the service are encouraged to provide the advisor with additional information—for instance, regarding risk tolerance or other asset holdings. They also authorize the advisor to set their portfolios' asset allocations, choose investments, and monitor

and rebalance their portfolios, all on a continuing basis. In effect, participants turn over management of their entire DC plan account to a third-party professional advisor.

Customizing at the individual level allows the participants' total financial picture—including other investment holdings that may be critical to a household's retirement readiness—to shape the design of their portfolio within their plan, leading to a truly optimized retirement investment approach.

In relation to TDFs, which are a preferred QDIA, managed accounts are often included as a complementary plan option, which works well for participants seeking an individualized approach.

### **Demographics of TDF and managed account investors**

Vanguard research indicates that new participants are driving TDF adoption. A total of 24% of Vanguard recordkeeping participants were invested in a single TDF in 2011, up sixfold over the previous five years. Among new plan entrants (those entering the plan for the first time in 2011), 64% of participants were invested in a single TDF (*How America Saves*, 2012).

Compared with the "average" participant, single-TDF investors are younger, relatively new to their plans, have low account balances, and have a higher incidence of being defaulted into this option as part of new-hire automatic enrollment (see **Figure 1**). In fact, 29% of single-TDF users are defaulted into this option under new-hire automatic enrollment. This higher default rate makes sense, given that single-TDF users tend to be younger and are more likely to be subject to automatic enrollment when joining a plan.

**Figure 1.** Single-TDF investors versus “average” participant

|                                 | Single-TDF participant | Average participant |
|---------------------------------|------------------------|---------------------|
| Average age                     | 40.4 years             | 45.7 years          |
| Median balance                  | \$5,438                | \$28,304            |
| Average tenure                  | 5.2 years              | 10.4 years          |
| Percentage male                 | 57%                    | 59%                 |
| Percentage defaulted            | 29%                    | 10%                 |
| <b>Percentage of population</b> | <b>24%</b>             |                     |

Notes: Demographic data as of December 2010; population percentage as of December 2011.

Source: Vanguard, 2012.

**Figure 2.** Managed account investors versus “average” participant

|                                 | Managed account participant | Average participant |
|---------------------------------|-----------------------------|---------------------|
| Average age                     | 49.2 years                  | 45.7 years          |
| Median balance                  | \$54,698                    | \$28,304            |
| Average tenure                  | 14.3 years                  | 10.4 years          |
| Percentage male                 | 58%                         | 59%                 |
| Percentage defaulted            | 5%                          | 10%                 |
| <b>Percentage of population</b> | <b>3%</b>                   |                     |

Notes: Demographic data as of December 2010; population percentage as of December 2011.

Source: Vanguard, 2012.

However, although the fraction of participants defaulted into TDFs is higher than for other managed allocation options, the vast majority—71%—of single-TDF investors are not defaulted (see Figure 1). They’re actually choosing this option on their own.

In terms of managed account investors, our research also shows that older participants tend to be attracted to this option (see Figure 2). With a median balance of nearly \$55,000, these investors also tend to have significantly higher account balances than younger participants. And managed account holders tend to be significantly longer-tenured employees. So, clearly, as people get older and accumulate larger balances, managed accounts can become a much more attractive option.

Again, it’s not surprising that a participant nearing retirement and with more at stake might find a more tailored approach attractive.

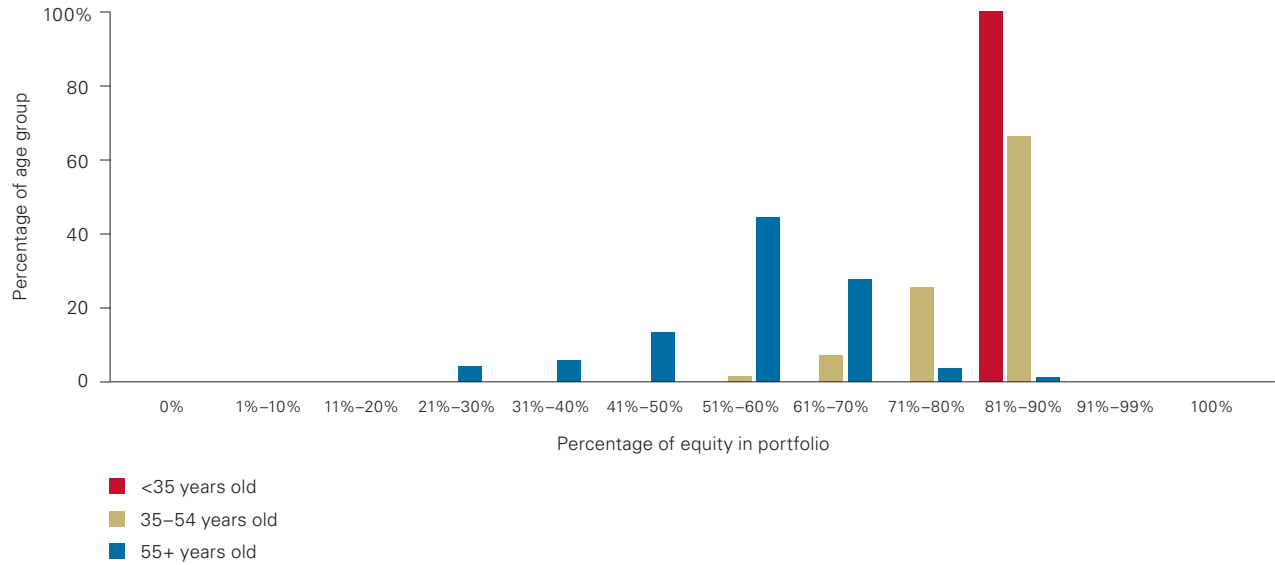
### Portfolio effects from TDFs and managed accounts

The emergence of professionally managed allocation strategies like TDFs and managed accounts has had two significant effects on portfolios. First is *improved age-adjusted equity allocations*. Participants in professionally managed allocations avoid extreme equity allocations and, in most cases, have predictable age variation in equity holdings (see data in the accompanying Figures 3–5). This finding is consistent with other research showing the benefit of such programs in improving diversification among various asset classes, reducing extreme risk and return outcomes, and reducing specific risk of employer stock (Utkus and Bapat, 2011).

As shown in Figure 3, on page 4, single-TDF investors tend to have age-appropriate asset allocations. Young investors have equity allocations of around 90%, and equity allocations are systematically reduced over time. In addition, there are no extreme equity positions—either 0% or 100% equities.

**Figure 3.** Single-TDF investors tend to have age-appropriate asset allocations

*Equity allocations shift with age*

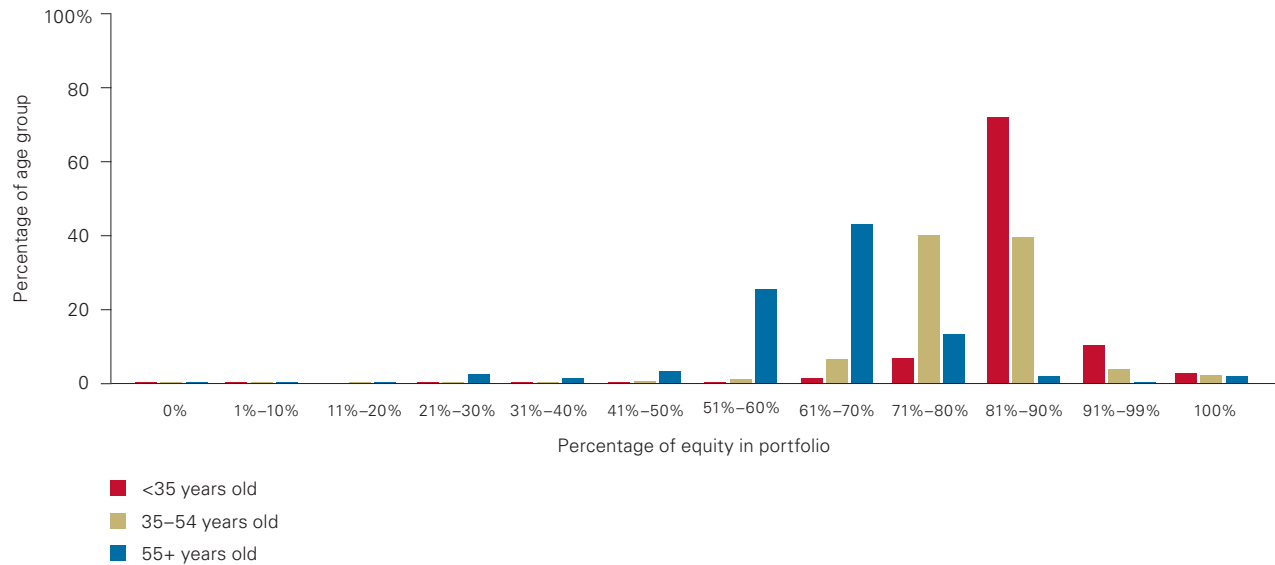


Note: Data as of December 2010.

Source: Vanguard, 2012.

**Figure 4.** Managed account investors tend to have wider age-varying equity allocations because of more customized advice programs

*Wider range of age-varying equity allocation due to customization*

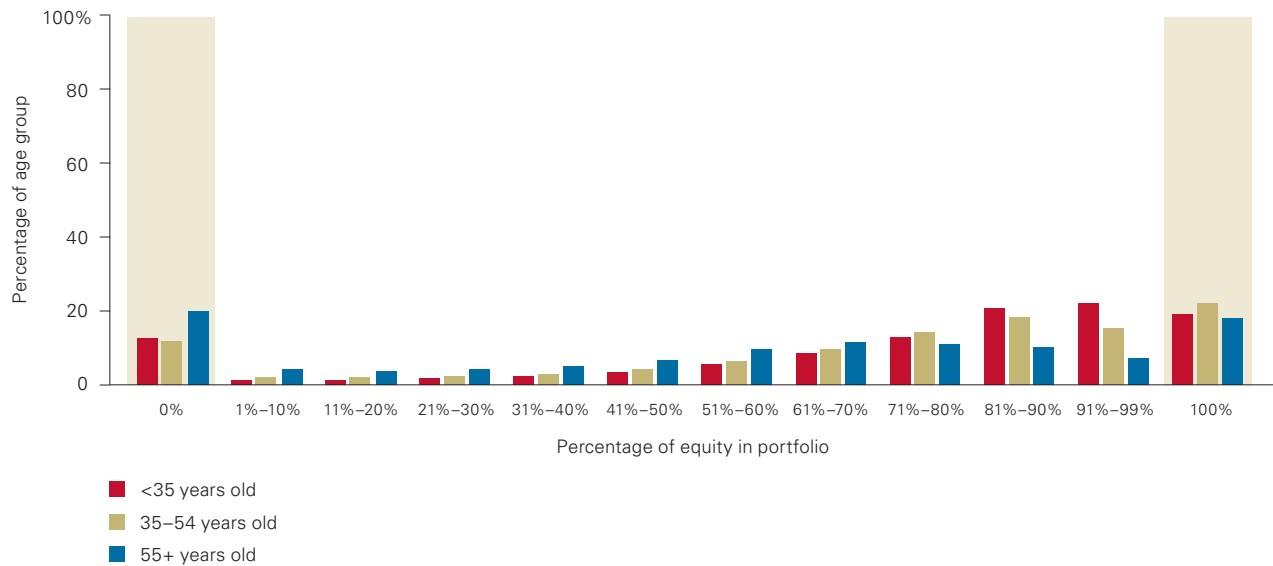


Note: Data as of December 2010.

Source: Vanguard, 2012.

**Figure 5.** Investors without professionally managed strategies tend to have less-appropriate asset allocations

Equity exposure varies broadly, with 31% of investors at the extremes



Note: Data as of December 2010.

Source: Vanguard, 2012.

Managed account investors have age-varying equity allocations similar to those of TDFs, although the range of results by age is wider, given the customized nature of the advice program (see **Figure 4**).

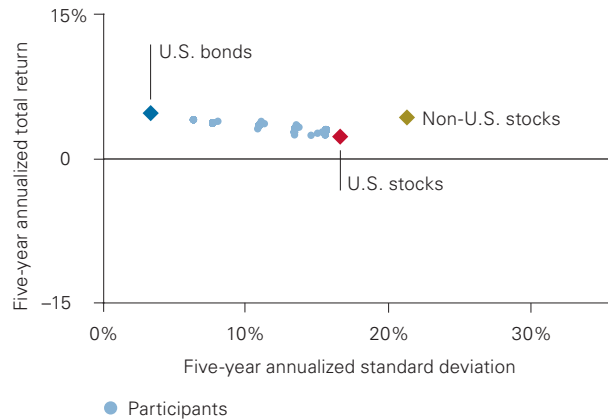
In contrast, participants not exclusively in professionally managed allocation strategies tend to have widely dispersed equity allocations (see **Figure 5**). Among participants younger than 35, 10% have zero equity allocation, while 39% have more than 90% of their portfolio in stocks. There are similar patterns for participants in other age groups. The trend toward professionally managed allocations can help reduce the number of participants holding extreme equity positions.

The second effect of professionally managed allocations is *reduced dispersion of risk-and-return outcomes*—thus introducing greater discipline and risk control in the asset allocation and portfolio construction process. **Figures 6–8** consider five-year risk–return metrics for each of the professionally managed options.

Single-TDF investors fall into a narrow band of risk–return because all the target-date portfolios in our sample are a specified combination of indexed U.S. equities, international equities, and U.S. bonds (see **Figure 6**, on page 6). In fact, the lack of dispersion for single-TDF investors masks the fact that there are more data here than can be seen in the figure. For every participant included in this sample (980 individuals), there is a dot on the figure. But most dots overlap because there are only a limited number of different TDF options. Because most of the points are identical and fall on top of one another, there appear to be dramatically fewer observations. This simple fact is worth emphasizing: *No matter how “customized” a set of TDFs is, the degree of variation in portfolio outcomes that is achievable by participants is limited to the number of portfolios offered.* For most plans offering a suite of TDFs that cover working-age individuals and an option for retirees, that is roughly 12 to 15 different portfolios.

**Figure 6.** Portfolio outcomes for single-TDF investors

*Limited range of outcomes in a logical sequence along the risk–return spectrum*



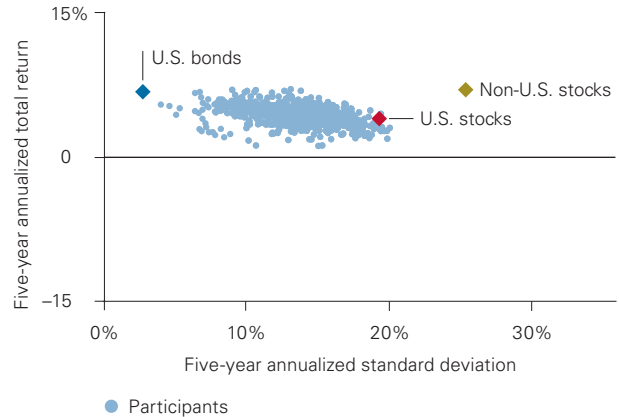
Notes: Includes 1,000 random participant accounts drawn from samples for single target-date investors. Excludes 0.5% top and 0.5% bottom outliers for both risk and return, for a net sample of 980 observations. Data cover the period December 2005 through December 2010. U.S. bonds are represented by Barclays U.S. Aggregate Bond Index; U.S. stocks are represented by MSCI US Broad Market Index; non-U.S. stocks are represented by MSCI All Country World Index ex US.

Source: Vanguard, 2011.

As shown in **Figure 7**, results for managed account investors are significantly more dispersed than those for single-TDF investors but still within an appropriate risk–reward range, reflecting exposure to the broad stock and bond markets. The greater dispersion shown reflects the fact that the managed account advice service can vary asset allocation and fund selection not only by age but also by other factors such as risk tolerance and participants’ broader financial picture. Managed account portfolios may also include active manager risk and, in some cases, exposure to company stock.

**Figure 7.** Portfolio outcomes for managed account investors

*Broader range of outcomes reflect customization*



Notes: Includes 1,000 random participant accounts drawn from samples for managed account investors. Excludes 0.5% top and 0.5% bottom outliers for both risk and return, for a net sample of 980 observations. Data cover the period December 2005 through December 2010. U.S. bonds are represented by Barclays U.S. Aggregate Bond Index; U.S. stocks are represented by MSCI US Broad Market Index; non-U.S. stocks are represented by MSCI All Country World Index ex US.

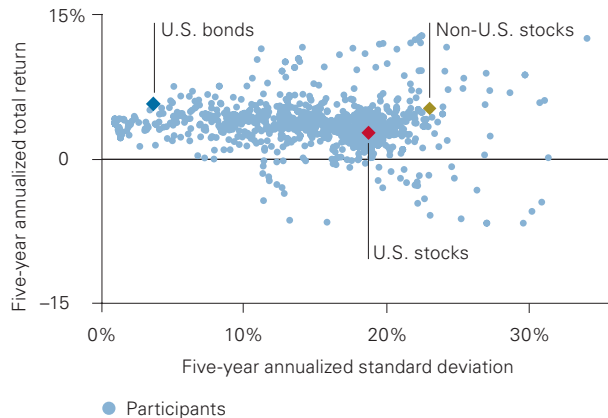
Source: Vanguard, 2011.

Some managed account strategies may also take nonplan assets into account—in which case the plan results shown here may be tailored to those nonplan holdings.

The greatest dispersion of results is among all other participants (see **Figure 8**). This range of outcomes is similar to what we might have seen before the introduction of TDFs and managed accounts. Reasons for the wide range of results include asset allocations overweighted to specific subasset classes; active manager risk exposure; concentrated positions in employer stock; trading and rebalancing activity (or the lack thereof) over time; and differences in recordkeeping and investment fees across plans and fund options.

**Figure 8.** Portfolio outcomes for investors who don't use professionally managed allocations

*Outcomes reflect a high degree of dispersion due to participants' varied asset allocations and plan characteristics; some portfolios show poor risk–return profiles.*



Notes: Includes 1,000 random participant accounts drawn from samples for managed account investors. Excludes 0.5% top and 0.5% bottom outliers for both risk and return, for a net sample of 980 observations. Data cover the period December 2005 through December 2010. U.S. bonds are represented by Barclays U.S. Aggregate Bond Index; U.S. stocks are represented by MSCI US Broad Market Index; non-U.S. stocks are represented by MSCI All Country World Index ex US.

Source: Vanguard, 2011.

For example, more dispersed outcomes might reflect that participant portfolios are invested overly conservatively or overly aggressively. Overly conservative participants might have all of their portfolios in money market or stable value assets. Overly aggressive participants might be overweighted in small-cap or emerging market stocks, have a large position in an actively managed equity fund, or have their portfolios concentrated in employer securities.

From a fiduciary perspective, this dispersion of risk–return characteristics shows that participants, especially those at the extremes, may potentially benefit from the use of a professionally managed account, regardless of their age, balance, tenure, or assets.

## The retirement savings spectrum

Vanguard believes that TDFs and managed accounts complement one another in a plan lineup and can serve different participants as they move along the retirement savings spectrum.

Low-cost, well-designed, passively focused TDFs can be appropriate for most participants. They tend to be especially appealing for less engaged participants, participants with lower balances, or younger participants just beginning to save for retirement. Well-designed TDFs can be an excellent core holding for retirement savers with any level of investment knowledge and sophistication, and plan sponsors often choose TDFs as the QDIA for their plans.

Managed accounts can be an excellent choice for the subset of participants seeking a more customized solution and willing to make the additional investment of their time and effort (e.g., by providing outside-the-plan financial data), although the ability to customize solutions generally introduces additional service costs relative to some TDFs. A managed account is often sought by participants who are more engaged, have higher account balances, and are further along the retirement savings spectrum. The complexity of the portfolio warrants a more complex form of advice, which comes at a relatively higher cost.

## Conclusion

TDFs and managed accounts offer many of the same benefits, including:

- A balanced approach.
- Professional investment management.
- Diversification.
- Elimination of extreme asset allocations.
- Age-appropriate design.
- Automatic rebalancing.

Together, however, they can cater to the needs of a diverse and changing population.

These two approaches have some key differences. For example, while TDFs are known for their low costs, limited participant involvement, and simple selection process, managed accounts offer greater personalization, somewhat higher costs, greater participant involvement, and a more complicated selection process.

So while adopters of TDFs and managed accounts tend to vary by age, tenure, and account balance, Vanguard research reported here has shown that both strategies are having similar and positive effects on portfolios, including introducing an age-related reduction of risk in asset allocation and more predictable return outcomes.

Offering a managed account option in addition to TDFs can help address the needs of diverse and evolving participant populations.

## References

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*Investments in target-date 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-date fund is not guaranteed at any time, including on or after the target-date.*