SEE INDEX-BASED TARGET DATE FUNDS DIFFERENTLY
From an aerial view, a neighborhood of similarly fashioned homes can all look the same. Same roof pitches and rectangular lawns, same swing sets and shrubbery. But as the lens comes closer, zooming in on the intricacies of each property, each structure, each appliance and electrical system, stark differences emerge. It’s within these differences that the home’s value can begin to be measured and a true comparison of benefits revealed.

Within the world of index-based target date funds (defined here as TDFs), relying on the aerial view to ascertain value can be as deceiving as estimating home prices from 50,000 feet in the air. A closer inspection is required.

Understanding and evaluating both the obvious and subtle dimensions of TDF value are critical responsibilities for consultants and investment committees. Here, we will explore three dimensions of TDFs and their relevance to participants:

**Structure**
The advantages of ERISA-qualified collective investment trusts (also known as commingled funds) vs. mutual funds

**Index Selection**
The benefits of diversifying asset classes, enhanced by thoughtful index selection

**Securities Lending**
The value of choice
Structure

Is it a tool shed or a work shop? While both structures contain the instruments required to get the job done, the better-equipped work shop supports a more sophisticated result. Similarly, TDFs that are structured as ERISA-qualified collective investment trusts (CITs), instead of mutual funds, are able to offer distinct advantages to participants.

Index-based target date funds are designed as fund-of-fund structures whereby the exposure to the individual stocks and bonds is obtained through investments in various underlying index funds. For example, an SSGA Target Retirement Fund will invest in eleven underlying index funds as the target date approaches. Both the target retirement funds and underlying index funds are structured as CITs.

SSGA’s decision to employ the CIT structure is purposeful and due to a host of advantages over mutual funds, such as greater opportunity for low cost trading (vis-à-vis unit and security crossing), more pricing flexibility, increased portfolio diversification without additional investment management fees, and reduced tax exposure on dividends. While most providers offer the CIT structure, some of these CIT structures are more optical than optimized.

For example, some providers structure the target date funds as CITs, only to invest the assets in those CITs into mutual funds. With mutual funds as the ultimate investment engine, TDFs are not able to deliver all of the benefits of a CIT structure to participants.

Figure 1: True CIT or Optical Illusion?

Source: SSGA Defined Contribution. Manager A information sourced from competitor websites and fact sheets.
Why does this matter?

Let’s take a closer look at income and tax implications within specific asset classes. With international equities, CITs offer a unique benefit to their underlying clients in that these vehicles are set up to receive dividends at a lower tax basis when compared to mutual funds. In short, lower tax exposure reduces costs, or increases returns, depending on one’s perspective. For example, based on 2016 tax tables, SSGA’s Global Equity Beta Solutions team estimates that an ERISA-qualified CIT benchmarked to the MSCI ACWI ex US IMI Index will have a 0.16% return (or cost) advantage when compared to a mutual fund with the same investments. Given the average TDF has a 23% allocation to international stocks\(^1\), a 0.16% difference in return (or cost) has a material and advantageous impact on the return (or cost) of the target date fund.

Figure 2 shows the additional return to the SSGA Target Retirement Funds based on the dividend tax benefit available in both the international stock allocation (benchmarked to MSCI ACWI ex US IMI Index) and the global REIT allocation (benchmarked to the FTSE ERPA/NAREIT Developed Liquid Index):

**Figure 2: CIT Tax Benefits Can Eclipse Fund Expenses, Revealing Overall Cost Advantages\(^*\)**

<table>
<thead>
<tr>
<th>Income</th>
<th>2050</th>
<th>2040</th>
<th>2030</th>
<th>2020</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategic Allocations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI ACWI ex US IMI Index</td>
<td>34.60%</td>
<td>32.60%</td>
<td>27.60%</td>
<td>17.60%</td>
<td>10.10%</td>
</tr>
<tr>
<td>FTSE Developed Liquid REIT Index</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Tax Benefit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI ACWI ex US IMI Index</td>
<td>0.16%</td>
<td>0.16%</td>
<td>0.16%</td>
<td>0.16%</td>
<td>0.16%</td>
</tr>
<tr>
<td>FTSE Developed Liquid REIT Index</td>
<td>0.12%</td>
<td>0.12%</td>
<td>0.12%</td>
<td>0.12%</td>
<td>0.12%</td>
</tr>
<tr>
<td><strong>Difference in Return (or Cost) due to Tax Benefit</strong></td>
<td>0.06%</td>
<td>0.05%</td>
<td>0.04%</td>
<td>0.03%</td>
<td>0.02%</td>
</tr>
</tbody>
</table>

\(^1\) Based on the Morningstar Industry Average Sub-Asset Class Glide Path
\(^*\) Based on the December 2017 TDF allocation
Source: SSGA Global Equity Beta Solutions team as of December 31, 2017
The Wide Angle: How Fund Structure Can Impact Value

Though they serve the same objective of populating TDFs with diverse, underlying index funds, CITs and mutual funds are not equal or interchangeable entities. Instead, CITs present a clear advantage. However, in order for users to capture the associated increased returns or lowered costs, the CIT structure must be authentic and not underpinned by mutual funds—a circular reference used by some top providers. For sponsors, understanding the fund structure is key to evaluating the value that it offers participants. Like the tool shed and work shop, while both structures contain similar components, the better-equipped environment facilitates a superior result.
Index Selection

Is it an in-ground pool or an in-law suite? Unique property features can broaden a home’s appeal and increase its value on resale, but they can also become a burden if not properly maintained. However, if done well and looked after carefully, these property attributes can buffer the home value through housing boom and bust cycles. The inclusion of diversifying asset classes within a TDF has a similar effect. The diversification is meaningful to the overall portfolio across market cycles, but must be carefully managed, beginning with index methodology.

TDFs cast a wider net of investable options to enable greater portfolio diversification. To maximize the value of the diversification, fund managers should scrutinize the underlying indices being tracked and determine how to control for systemic issues inherent to these investments. For example, consider the indices SSGA utilizes for both commodities and high yield; two asset classes which are rarely found in index-based Target Date Funds given concerns related to the efficacy of index-based implementation.
Commodities: Importance of Roll Returns

When evaluating commodities as part of SSGA's regular asset class selection process, we were concerned that passive investors might not be able to fully reap the diversification and inflation-hedging benefits due to the roll risks. Working in conjunction with members from our Global Equity Beta Solutions team (GEBS), we evaluated multiple commodity indices and selected the Bloomberg Roll Select Commodities Index. Following a rules-based approach, the Roll Select Commodity Index seeks to limit the effects of roll risk (or “contango”), which can adversely affect passive commodity investors who are neither watching nor adjusting for the rise and fall of commodity futures. Since adding this asset class to the TDFs in June 2012, the ‘Roll Select’ index has out-performed the first generation Bloomberg Commodity Index by 1.5% on an annualized basis.

Figure 3: ‘Roll Select’ Returns Illustrate the Importance of Thoughtful Index Selection

Source: Bloomberg, SSGA
All returns for the Roll Select before July 18, 2011 have been back-tested and are provided for illustrative purposes only. Past performance, including back-tested performance, is not indicative of future performance.
High Yield: Managing Liquidity Risk

High yield investing offers the benefits of equities and fixed income while potentially limiting the downside risks associated with both. Utilized properly within a glidepath, it allows a manager to bolster expected balances prior to retirement while also protecting against longevity risk after the participant has exited the workforce.

However, high yield (HY) does present the challenge of lower liquidity in the face of DC cash flow requirements. That is, a HY indexer that uses a non-filtered index would be forced to hold illiquid HY securities that may suffer significantly in a market downturn if the indexer were forced to sell. Consider this scenario through the lens of the commercial real estate market during the Financial Crisis. In this context of economic stress, portfolio managers would be hard-pressed to deliver liquidity if redemptions were requested.

To address the strategies’ daily cash flow needs SSGA has chosen to utilize the Bloomberg Barclays U.S. High Yield Very Liquid Bond Index. This index stands out as following simple, objective rules to deliver a liquid index while still retaining the potential benefits of High Yield investing:

- Issuer exposure is capped at 2% (CAP)
- Minimum Amount Outstanding of an issue must be equal to or greater than 500mn (Size Rule)
- Bond must have been issued within the last 5 years (Age Rule)
- Maximum maturity of 15 years (Maturity Rule)
- Excludes PIK and non-rated securities (NR Ratings/PIK Rule)

The benefits of our index selection can be quantified by the low degree of tracking error (average monthly variance of -0.04%) and strong correlation to the broader Bloomberg US High Yield Index (0.99) since its’ addition to the SSGA TDFs in January 2010. Further, while some index-based managers argue that it is necessary to employ active management when investing in high yield, the HY VLI index has delivered above-median returns when compared to the Morningstar universe of active managers (Figure 4).

Figure 4: Beating the Median: US High Yield – Universe Return Statistics
Total Returns, Ending September 30, 2017

<table>
<thead>
<tr>
<th></th>
<th>Median</th>
<th>BBG U.S. High Yield Very Liquid Index (USD) (TOT)</th>
<th>Over Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>QTD</td>
<td>1.82</td>
<td>1.83</td>
<td>+1%</td>
</tr>
<tr>
<td>1 Year</td>
<td>7.83</td>
<td>8.34</td>
<td>+7%</td>
</tr>
<tr>
<td>3 Year</td>
<td>4.50</td>
<td>5.21</td>
<td>+16%</td>
</tr>
<tr>
<td>5 Year</td>
<td>5.34</td>
<td>5.83</td>
<td>+9%</td>
</tr>
<tr>
<td>Entire Period</td>
<td>7.18</td>
<td>7.92</td>
<td>+10%</td>
</tr>
</tbody>
</table>

Source: SSGA, Factset as of September 30, 2017
The Wide Angle: How Thoughtful Diversification Benefits Outcomes

Including commodities, high yield, and other diversifying assets in TDFs can improve risk-adjusted returns, mitigate specific risks (such as inflation), and ultimately increase net retirement savings. Thanks to SSGA’s use of the CIT investment structure, these diversification benefits can be gained without the accrual of additional investment management fees at the underlying fund level— an advantage that mutual funds cannot offer.

Some competitors say the contribution of diversifying assets comes at too high a price; increasing cost, introducing complexity, lowering transparency, and reducing liquidity for both plan sponsors and participants. At SSGA, we are mindful of these potential pitfalls and vigilant in side-stepping them, beginning with the thoughtful employment of a CIT investment structure as well as specific indexes to maximize return while monitoring volatility.

Maintaining unique features of a portfolio or home can require more intellectual or physical elbow grease—with the objective of a greater and more secured return. At SSGA, we believe that’s an end that’s worth the effort.
The Wide Angle: How Choice is an Advantage in Securities Lending

A well-managed securities lending program can add attractive risk-adjusted returns to participants’ portfolios; however, for the program to be successful, it requires plan sponsor buy-in as well as participant education and ongoing communications. Not all organizations embrace this complexity, instead, a solid set of shingles adequately cover their needs. To accommodate a range of appetites and aptitudes, SSGA offers lending and non-lending solutions, delivering plan sponsors the benefit of choice and participants the value of clarity.

What is securities lending?

In a securities lending transaction, securities are temporarily transferred by one party (the lender) to another (the borrower). The borrowers are brokers, dealers, and other financial institutions, which provide collateral in return for the loan. The lender retains the economic benefits associated with ownership of the loaned securities such as the dividends and corporate action entitlements. The borrower is contractually obligated to return the securities upon recall by the lender. The borrower pays a fee to the lender for the use of the borrowed securities.

Securities Lending

Is the roof covered in solar panels or simply shingles? While solar panels can offer the rewards of lower utility bills and environmental stewardship, they also introduce risks, such as potentially complex installation and unforeseen maintenance costs. For plan sponsors, choosing securities lending offers a similar challenge in striking the right balance between potential reward and potential risks. Communicating these trade-offs to participants can present a messaging hurdle that, for some, is too high. Therefore, having the option of securities lending is critical.

Plan sponsors’ participation in a securities lending program should be the result of a carefully considered and embraced choice and not a default fund feature. However, some leading managers are not able to offer a non-lending option as their TDFs invest in mutual funds that automatically participate in securities lending. In such scenarios, the limit of the offering translates into limits on sponsors’ decision-making autonomy.

Within SSGA’s CITs, we offer both non-lending and lending options and counsel clients to approach the decision thoughtfully by outlining risk/return objectives. For some sponsors, this assessment will reveal that the trade-offs are not aligned with organizational attitudes or Defined Contribution (DC) plan values and elect for a non-lending solution. Often in these cases, sponsors are stymied by the prospect of communicating a securities lending program—and the associated risks and returns—to their participants.

For those organizations that choose lending, decisions-makers should become familiar with the ranging differences between programs. For a complete picture, sponsors should look beyond returns on lending to understand how revenues and expenses of the program are allocated amongst the parties (including collateral reinvestment and manager fees), how risk management is approached, and how the risk outlook impacts returns.

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Using such a singular criteria as cost to evaluate TDFs assumes that all options are created equally—a myopic perspective that we hope to have broadened. Pulling our lens back from the neighborhood we have been so closely inspecting, we can now see in greater detail the opportunities and limitations contained within each property. For SSGA, this means a more detailed and sound structure (CITs), the availability and careful oversight of unique features (diversifying asset classes), and the choice of additional complexity (securities lending). When brought under one roof, these value dimensions total to more than just curb appeal; they deliver a seamlessly sophisticated investment structure.
About Us
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*AUM reflects approximately $32.4 billion (as of December 31, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.