ebri.org
Employee Benefit Research Institute

March 2009 • No. 327

Issue BRIEF

Use of Target-Date Funds in 401(k) Plans, 2007

By Craig Copeland, EBRI

EXECUTIVE SUMMARY

WHAT THEY ARE: Target-date funds (also called "life-cycle" funds) are a type of mutual fund that automatically rebalances its asset allocation following a predetermined pattern over time. They typically rebalance to more conservative and income-producing assets as the participant's target date of retirement approaches.

WHY THEY'RE IMPORTANT AND GROWING: Of the 401(k) plan participants in the EBRI/ICI 401(k) database who were found to be in plans that *offered* target-date funds, 37 percent had at least some fraction of their account in target-date funds in 2007. Target-date funds held about 7 percent of total assets in 401(k) plans and the use of these funds is expected to increase in the future. The Pension Protection Act of 2006 made it easier for plan sponsors to automatically enroll new workers in a 401(k) plan, and target-date funds were one of the types of approved funds specified for a "default" investment if the participant does not elect a choice.

EBRI/ICI 401(K) DATABASE: This study uses the unique richness of the data in the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, which has almost 22 million participants, to examine the choices and characteristics of participants whose plans offer target-date funds.

EFFECT OF AGE, SALARY, JOB TENURE, AND ACCOUNT BALANCE: Younger workers are significantly more likely to invest in target-date funds than are older workers: Almost 44 percent of participants under age 30 had assets in a target-date fund, compared with 27 percent of those 60 or older. Target-date funds appeal to those with lower incomes, little time on the job, and with few assets. On average, target-date fund investors are about 2.5 years younger than those who do not invest in target-date funds, have about 3.5 years less tenure, make about $11,000 less in salary, have $25,000 less in their account, and are in smaller plans.

EFFECT OF AUTOMATIC ENROLLMENT: While the EBRI/ICI database does not contain specific information on whether a 401(k) plan had automatic enrollment, this analysis was able to proxy for those who could be identified as automatically enrolled. The data show that workers who were considered to be automatically enrolled in their employer's 401(k) plan are significantly more likely to invest all their assets in a target-date fund than those who voluntarily joined, and were also less likely to have extreme all-or-nothing asset allocations to equities.

EQUITY ALLOCATIONS AND FUND FAMILIES: One of the major questions surrounding target-date funds is the equity allocations that these funds use over time (the so-called "glide path") as a participant's retirement target date approaches. The glide paths of different target-date funds have significantly different shapes and starting/ending equity allocations. As of 2007, the equity allocation ranges from about 80–90 percent for 2040 funds (for workers about 30 years away from retirement), and from 26–66 percent for 2010 funds (for workers one year away from retirement)—a 40 percentage-point difference. Moreover, the fund families change their relative rank in equity allocation within the different fund years. This analysis finds that the relative rank of the equity allocation within a target-date fund does not appear to affect the percentage of participants investing all their account into that fund. Nevertheless, investors in specific fund families are more likely to invest all their assets in a single target-date fund from that family.

Endnotes

[1] See Nevin Adams, "Senate Committee Takes Aim at Target-Date Funds," *planadvisor* (Feb. 25, 2009), online at www.planadviser.com/compliance/article.php/3804

[2] Asset managers from different organizations commonly use different strategies and asset allocations for funds that carry similar or identical names to those offered by other organizations. For example, many organizations market an "international fund" that holds different securities and has a different allocation among the securities but under the same name as that offered by others. In other words, such differences across providers are not limited to target-date funds.

[3] For example, Vanguard recently released a comprehensive study on target-date fund use in the plans they administer. See Nessmith and Utkus, 2008.

[4] The EBRI/ICI Participant-Directed Retirement Plan Data Collection Project is the largest, most representative repository of information about individual 401(k) plan participant accounts. As of December 31, 2007, the EBRI/ICI database includes statistical information about 21.8 million 401(k) plan participants, in 56,232 employer-sponsored 401(k) plans, holding $1.425 trillion in assets. The 2007 EBRI/ICI database covers 45 percent of the universe of 401(k) plan participants, 12 percent of plans, and 47 percent of 401(k) plan assets. The EBRI/ICI project is unique because of its inclusion of data provided by a wide variety of plan recordkeepers and, therefore, portrays the activity of participants in 401(k) plans of varying sizes—from very large corporations to small businesses—with a variety of investment options. See VanDerhei, Holden, Alonso, and Copeland (2008) for overall asset allocation of the participants in the database.

[5] The salary breakout only includes those participants with complete salary data, which is about 14 percent of the sample of those investing in target-date funds, or almost 700,000 participants.

[6] Fidelity Investments found that the percentage of plans that they administer that offered automatic enrollment increased from 2 percent in 2006 to 16 percent in 2008. The percentage of plans that have life-cycle or target-date funds as the default investment option increased from 14 percent in 2006 to 60 percent in 2008 (Fidelity Investments, Early Progress with Auto Features in 401(k) Plans, presentation February 12, 2009). In Hewitt Associates' (2009) annual survey of about 150 mid- to large-sized employers, it was found that 51 percent offered automatic enrollment as of January 2009, up from 44 percent in 2008. Furthermore, 25 percent of those not offering the feature were somewhat or very likely to add it for new hires, down from 57 percent in 2008.

[7] See Fidelity op. cit.

[8] Choi, Laibson, Madrian, and Metrick (2004) found that participants defaulted into a specific investment option have a strong likelihood of remaining in that option.

[9] Vanguard found 15 percent of the plans they administer had adopted automatic enrollment by the end of 2007. Eighty percent of these plans had a target-date fund as the default investment. See Nessmith and Utkus, 2008, for further information.

[10] The figures will use the label "2000" for target-date funds with the name of "Retirement Income," "Target Now," or "Target Today," which are designed for participants who are past their expected year of retirement.

[11] The terms *total equity allocation* or *equity allocation* include the equity allocation inside the target-date fund combined with that outside the target-date fund. When focusing only on the equity allocation outside of the target-date fund, the term *outside equity allocation* is used.

[12] The tenure breakdown includes only those observations with tenure date (93 percent of the target-date fund participant sample has tenure data).

[13] At the end of 2006, Fidelity reported that plans with less than 25 participants had on average of 17 fund options, compared with 39 options for those in plans with 10,000–24,999 participants and 43 for those in plans with 25,000 or more participants (Fidelity 2007).

[14] One exception did emerge for participants of plans with 5,001 to 10,000 participants, where the percentage in funds dated 2015 or earlier fell below 8 percent. No other plan size was below 9.4 percent or above 11.9 percent. Among participants in plans with more than 10,000 participants, 10.9 percent were in funds dated 2015 or earlier, compared with 10.3 percent for the smallest plans.

[15] The age distribution between those with and without company stock is relatively similar, but there is a somewhat larger percentage of older participants with company stock than without. The average age of those with company stock was 43.6 years, compared with 42.5 years for those without company stock. The similar age distributions could be driving the similar distributions in target-date years. The slightly older distribution could be leading to slightly lower percentages of using target dates of 2030 or later.

[16] The asset allocations of the target-date funds are as reported by Target Data Analytics from Morningstar Principia. They are for the closest date to the end-of-year 2007 that were available in the data. Target Data Analytics has established a set of benchmark indexes for target-date funds. For more information, see www.TDBench.com

[17] In future Employee Benefit Research Institute research, optimal glide paths for plans with different participant characteristics will be investigated.

ebri.org
Employee Benefit
Research Institute

Issue BRIEF

EBRI Employee Benefit Research Institute Issue Brief (ISSN 0887−137X) is published monthly by the Employee Benefit Research Institute, 1100 13th St. NW, Suite 878, Washington, DC, 20005-4051, at $300 per year or is included as part of a membership subscription. Periodicals postage rate paid in Washington, DC, and additional mailing offices. POSTMASTER: Send address changes to: *EBRI Issue Brief,* 1100 13th St. NW, Suite 878, Washington, DC, 20005-4051. Copyright 2009 by Employee Benefit Research Institute. All rights reserved. No. 326.

Who we are

The Employee Benefit Research Institute (EBRI) was founded in 1978. Its mission is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI is the only private, nonprofit, nonpartisan, Washington, DC-based organization committed exclusively to public policy research and education on economic security and employee benefit issues. EBRI's membership includes a cross-section of pension funds; businesses; trade associations; labor unions; health care providers and insurers; government organizations; and service firms.

What we do

EBRI's work advances knowledge and understanding of employee benefits and their importance to the nation's economy among policymakers, the news media, and the public. It does this by conducting and publishing policy research, analysis, and special reports on employee benefits issues; holding educational briefings for EBRI members, congressional and federal agency staff, and the news media; and sponsoring public opinion surveys on employee benefit issues. **EBRI's Education and Research Fund** (EBRI-ERF) performs the charitable, educational, and scientific functions of the Institute. EBRI-ERF is a tax-exempt organization supported by contributions and grants.

Our publications

EBRI Issue Briefs are periodicals providing expert evaluations of employee benefit issues and trends, as well as critical analyses of employee benefit policies and proposals. ***EBRI Notes*** is a monthly periodical providing current information on a variety of employee benefit topics. EBRI's ***Pension Investment Report*** provides detailed financial information on the universe of defined benefit, defined contribution, and 401(k) plans. EBRI ***Fundamentals of Employee Benefit Programs*** offers a straightforward, basic explanation of employee benefit programs in the private and public sectors. The ***EBRI Databook on Employee Benefits*** is a statistical reference work on employee benefit programs and work force-related issues. www.ebri.org

Orders/ Subscriptions

Contact EBRI Publications, (202) 659-0670; fax publication orders to (202) 775-6312. Subscriptions to *EBRI Issue Briefs* are included as part of EBRI membership, or as part of a $199 annual subscription to *EBRI Notes* and *EBRI Issue Briefs.* Individual copies are available with prepayment for $25 each (for printed copies). ***Change of Address:*** EBRI, 1100 13th St. NW, Suite 878, Washington, DC, 20005-4051, (202) 659-0670; fax number, (202) 775-6312; e-mail: subscriptions@ebri.org ***Membership Information:*** Inquiries regarding EBRI membership and/or contributions to EBRI-ERF should be directed to EBRI President/ASEC Chairman Dallas Salisbury at the above address, (202) 659-0670; e-mail: salisbury@ebri.org

EBRI Issue Brief is registered in the U.S. Patent and Trademark Office. ISSN: 0887−137X/90 0887−137X/90 $ .50+.50