The Glide Path Selection Problem
A Quantitative Approach to Assessing Glide Path Fit for DC Participants

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The target-date selection process has been oversimplified, with plan sponsors and their consultants focusing on alpha attributes, such as cost and the preference for active management while underestimating beta attributes, such as glide path design and suitability to participants. For many plan sponsors, target-date selection has been as simple as accepting their recordkeeper’s target-date product. A 2015 study by CapTrust Advisors found that 45% of plan sponsors utilized the series of target-date funds offered by their recordkeepers. In fact, 6 of the 10 largest recordkeepers are also the largest providers of target-date products—a surprising statistic given the number of products available to plans.¹

The target-date decision is complex, with many variables, including some that are difficult to quantify. Historically, the target-date decision has lacked consideration for glide path design, resulting in a high degree of potential mis-match between the equity glide path used by the plan sponsor, and the optimal glide path for the specific demographics of the plan participants. This paper will show that beta, or glide path appropriateness, is one of the most important aspects of the target-date decision, and that Morningstar has developed a quantitative framework to help solve this problem.

Current Target-date Offerings
Off-the-shelf target-date products are conceived and built using average U.S. demographic data and are designed to provide a typical investor with exposure to a well-diversified portfolio that becomes more conservative as the investor nears retirement. These target-date products are often built for a specific type of investor; for example, investors who prefer to derisk quickly, investors who have a high risk appetite, or investors who are primarily focused on capital preservation. Recognizing that all glide paths are not the same, and that “one size does not fit all,” it follows that the shapes of individual glide paths can be vastly different, as depicted in Figure 1. Among the 60 target-date funds studied in the Morningstar Target-Date Report², there is a 30-percentage point equity allocation differential at the starting point of the target-date series. Likewise, there is a 42.5-point equity difference at the termination point among the different series. Not surprisingly, there are countless glide path designs throughout the dataset studied.

Moreover, even among the top 5 target-date providers by assets, we find great variation in the bond and stock mixes of the glide paths, as illustrated in Figure 2. For example, there is a 16% difference in the equity allocation between the 2030 Funds of these providers.
Significant differences within products make the target-date decision perplexing for even the sophisticated investment committees. In February 2013, the Department of Labor provided guidance to plan sponsors, advising that it is a “best practice” to discuss specific characteristics of their participant population with prospective target-date fund providers. These particular characteristics may include salary levels, turnover rates, concurrent participation in a defined benefit plan, contribution rates, and withdrawal patterns. Current methods for evaluating the risk capacity of plan participants to aid in glide path selection are sparse and are largely qualitative in nature, thus offer plan sponsors little guidance. Further, we believe that it is impossible—and imprudent—to accurately determine an appropriate glide path by filling out a questionnaire. The most reliable method for assessing the risk capacity of a plan is to perform a quantitative analysis of the plan’s participants, to determine the risk capacity, or appropriate equity exposure, of a specific plan.

Selecting the correct glide path is one of the most important decisions that a plan sponsor or consultant can make.

The Morningstar Glide Path Selection Tool
For more than a decade, Morningstar Investment Management LLC has been providing retirement managed accounts and custom target-date services. Building on this experience and on the principles outlined in our total wealth methodology, our new innovative offering, the Morningstar Glide Path Selection Tool is designed to help address many of the inherent complexities in selecting an appropriate glide path. This quantitative approach helps plan sponsors determine the optimal glide path for their retirement plan, using the actual underlying data of plan participants. Leveraging the Morningstar® Wealth Forecasting Engine, an asset class and economic forecasting tool, which is used to power the retirement projections that help us deliver personalized asset allocation recommendations to millions of participants who use Morningstar Investment Management’s managed account, online advice, and custom target-date solutions; the Glide Path Selection Tool uses Morningstar Investment Management’s intellectual property to provide a lens into the appropriate equity portfolio for every single participant, providing insight into what the optimal risk level is for a median cohort, such as a the total participant base in a given retirement plan.

The tool provides an in-depth analysis of plan participants’ balance sheets, using factors such as each participant’s age, account balance, salary, deferral rate, and defined benefit plans. After collecting the basic participant data (no personally identifiable information is required), we analyze it and recommend a best-fit target-date series. A sample of four different hypothetical cases is displayed below. Each case highlights how specific participant characteristics can change the shape of a glide path based on data that the plan sponsor made available to Morningstar Investment Management.

3 http://www.dol.gov/ebsa/newsroom/tdf.html
Case 1: Large Manufacturing Firm

This plan’s workforce has slightly lower than average salaries, average balances, and slightly higher than average deferrals. This analysis of participant demographic data, shows the desired median participant equity risk closely aligns with the Morningstar® Lifetime Moderate IndexSM series.

Case 2: Leading Technology Firm

This plan’s workforce has higher than average salaries, balances, and deferrals. This analysis of participant demographic data, shows the desired median participant equity risk closely aligns with the Morningstar® Lifetime Aggressive IndexSM series.
This plan’s workforce has lower than average salaries, balances, and deferrals. This analysis of participant demographic data, shows the desired median participant equity risk closely aligns with the Morningstar® Lifetime Conservative Index® series.

Case 3: National Retailer

For illustrative purposes only.

This plan’s workforce has above average salaries and balances, and average deferrals. They also have a very generous ESOP plan. This analysis of participant demographic data, shows the desired median
participant equity risk does not align directly with the Morningstar® Lifetime IndexSM series. This plan may want to consider more customized options, such as a custom target-date solution.

Conclusion
With so many assets flowing into target-date funds, it is imperative that plan sponsors diligently select the glide path most appropriate for their participants. Gone are the days of choosing funds based on ease of implementation, low cost or proprietary product. The defined contribution industry now acknowledges there is a need to match glide path design with plan-specific data. Morningstar Investment Management has consistently found that glide paths take on many shapes to fit the needs of different participant data and that each population of participants is unique. Different salary ranges, balances, deferrals, defined benefit plans, and age distributions can have a large impact on the target asset allocation of an individual. These differences at the individual level, when summed together, lead to differences at the plan level—differences that are commonly ignored in the traditional target-date selection process.

A quantitative framework that takes into account the unique factors of the plan participant’s demographics is an optimal approach to glide path selection. The Morningstar Glide Path Selection Tool offers an innovative solution to a common problem that plan sponsors and consultants encounter.
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Morningstar Investment Management LLC offers the Morningstar Glide Path Selection Tool to assist plan sponsors in the determination of an appropriate glide path for their plan. Estimated plan participant asset allocations are determined using basic data provided by the plan sponsor, which Morningstar Investment Management does not independently verify. Particular investment options may not be appropriate investments for your plan, and there may be other investment options that are more suitable. The information, data, and opinions that are part of the tool and any related output generated includes proprietary information of Morningstar Investment Management and may not be copied or redistributed for any purpose. Morningstar Investment Management does not warrant this information to be accurate, complete, or timely and is not responsible for any damages or losses arising from the use of this information. The Morningstar Glide Path Selection Tool should not be the only method by which an investment or a particular investment option is chosen for a plan.

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