The heart of the debate on target date glide paths has been how much equity exposure a participant should have. There is a perception in the marketplace that target date funds approach equity similarly, and that the chief question is how much exposure exists near and after retirement – when participants want to lower volatility and preserve capital.

However, we feel that an important question often gets lost in discussions about the amount of equity exposure: namely, what type of equity exposure should an investor have near and after retirement? The answer is important because not all equity is created equal when it comes to volatility. Dividend-paying equities have historically tended to be less volatile than higher beta emerging markets and small-cap equities.

We believe that target date series should feature not only a gradual reduction in equities over time, but also a gradual shift in the nature of that equity exposure. This transition, which we call recharacterizing the equity exposure, effectively creates a Glide Path Within a Glide Path that can help lower volatility.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.
Recharacterize the equity to manage volatility

We believe that target date funds should seek to lower equity volatility as participants age by gradually shifting the exposure toward historically less volatile, income-oriented strategies and away from higher beta stocks – an approach we call recharacterization of equity. We believe plan sponsors and participants can benefit from this approach of essentially creating a Glide Path Within a Glide Path.

A reduction in equity volatility can help address the trade-off between market risk (volatility) and longevity risk (outliving assets) in target date funds. Historically, equities have tended to generate greater returns than fixed income, but with greater volatility. Therefore, an increased allocation to equities can reduce longevity risk but also increase market risk.

A recharacterization of the equity helps mitigate this trade-off. This approach lowers the equity exposure while at the same time changing the character of the equity by emphasizing income-oriented funds invested in companies that have the potential to pay and grow dividends. In contrast, a traditional static approach typically reduces equity in a one-dimensional, linear manner, keeping the mix of growth and income strategies relatively constant along the glide path.

In addition, lower equity volatility can reduce the burden on fixed income to deliver the income and downside protection needed late in the glide path. This can provide managers more flexibility to pursue a broader set of fixed income strategies targeting higher yield and total return.

A dynamic equity glide path increases the emphasis on income and reduces the emphasis on growth as participants age.
Emphasizing income can help manage equity volatility

The key to the Glide Path Within a Glide Path is to reduce the allocations to higher beta equity strategies, such as small-cap and emerging markets stocks, and to increase the role of dividend-oriented strategies near and after retirement. This is the approach taken by the American Funds Target Date Retirement Series®. These charts show the percentage of the glide path’s equity allocation by income orientation of the underlying equity funds, as reflected by 12-month distribution rates as of September 30, 2018.

A dynamic equity glide path increases the focus on income.

The charts show the percentage of the glide path’s equity allocation based on the income orientation of the underlying funds. Underlying equity funds are segmented into three bands based on 12-month distribution rates: those with distribution rates above 3%, those with rates between 1.5% and 3%, and those with rates below 1.5% (Class R-6 shares). Although past results are not predictive of results in future periods, a dynamic equity glide path is designed to allocate more of the equity exposure to underlying funds with a greater income orientation as participants age. The American Funds Target Date Retirement Series glide path, seen in the upper chart, is designed to increase allocations to historically higher yielding underlying funds over time. Meanwhile, a target date series following a static approach would keep its income orientation relatively constant, as in the lower chart.
The differences in volatility between a dynamic and static approach are the product of the equity glide path’s emphasis on less volatile income-oriented strategies and its lower allocation to higher beta equities such as emerging markets and small-cap stocks. As participants age, the dynamic equity glide path is designed to increase the allocation to underlying funds with a history of less volatility. The charts below divide the allocations to underlying equity funds by bands of 10-year standard deviations along the glide path. A dynamic glide path, represented by the American Funds Target Date Retirement Series in the upper chart, increases the allocation to historically less volatile income-oriented equity funds as participants age while lowering the allocation to what are viewed as more volatile growth-oriented funds. In contrast, a static approach keeps the volatility mix of underlying equity funds relatively constant even at retirement—the time when workers are most in need of volatility reduction to help meet the goals of capital preservation and income. Plan sponsors can assess the degree of their series’ recharacterization effort by looking at whether the underlying equity funds used later in the glide path have a history of lower volatility than the funds used early on.

A dynamic glide path gradually shifts the equity exposure toward historically less volatile underlying funds.

The charts show the percentage of the glide path’s equity allocation in underlying funds according to volatility. We segmented the underlying funds into three bands based on 10-year standard deviations. The determination of what constitutes “higher,” “medium” and “lower” volatility is based on historical volatility of market indexes over the past decade. Although levels of volatility can vary over time, a dynamic equity glide path is designed to allocate more assets to less volatile income-oriented underlying funds and less to what have generally been more volatile growth-oriented strategies in the later stages of the glide path. The American Funds Target Date Retirement Series, seen in the upper chart, is designed to increase the use of lower volatility funds as participants age. Meanwhile, a target date series taking a static approach would keep the allocations to differing volatility bands relatively constant.
We’ve already described two tools that plan sponsors can use to assess the degree by which a target date series pursues a dynamic approach to equity: looking at the change in standard deviations and distribution rates of the underlying equity funds along the glide path. Another way is to compare the Morningstar ownership zones for different vintages along the glide path to detect stylistic differences. If a target date series recharacterizes its equity, one would expect the style of the equity exposure to become less oriented toward growth- and small-cap stocks as retirement approaches.

In contrast, for target date series with relatively static equity allocations, one would expect to find very similar styles across the glide path. The dynamic equity allocation, represented by the American Funds Target Date Retirement Series, exhibits noticeable style differences between the series’ 2060 and 2020 vintages as of September 30, 2018. The 2020 fund has less of an emphasis on small-cap and growth-oriented stocks than its 2060 counterpart. Meanwhile, a target date series that took a static approach would demonstrate similar styles between vintages, as seen in the chart to the right.

Dynamic vs. Static equity in Morningstar Ownership Zones

The charts show the equity style differences between the 2060 and 2020 vintages of the American Funds Target Date Retirement Series as of September 30, 2018, according to Morningstar data, along with a conceptual illustration of a static approach. The American Funds’ 2020 vintage has less of an emphasis on growth-oriented and small-cap stocks than its 2060 counterpart. Meanwhile, a target date series that took a static approach would demonstrate similar styles between vintages, as seen in the chart to the right.

Using style differences to gauge recharacterization of the equity exposure

Dynamic equity allocation
American Funds Target Date Retirement Series as of June 30, 2017

Static equity allocation

Dynamic vs. Static equity in Morningstar Ownership Zones
When it comes to implementing a Glide Path Within a Glide Path, we believe objective-based management can provide advantages. In contrast to an objective-based approach, many target date glide paths are based purely on asset classes. These glide paths specify the overall balance between equity and fixed income, while also typically breaking down the equity exposure into geographic or market-cap categories, or both. Although geography and market-cap criteria clearly have volatility implications, target date series that base their glide paths solely on these distinctions can miss an opportunity to focus on something that is tangible and more relevant to participants near and in retirement: income. These funds can miss an opportunity to pursue dividend-paying and dividend-growing equities that have historically been less volatile than other stocks.

An objective-based glide path manages investments in line with investors’ changing goals over the savings cycle: appreciation in the early working years (known as the accumulation stage), appreciation with downside protection near retirement (known as the transition stage), and asset preservation and income during retirement (known as the distribution stage). In accordance with those shifting objectives, the American Funds Target Date Retirement Series shifts the equity exposure over time. It emphasizes growth funds and growth-and-income funds in the accumulation stage, growth-and-income and equity-income funds in the transition stage, and equity-income and balanced funds in the distribution stage. The focus on dividend-growing and dividend-paying equities is designed not only to help reduce volatility as participants approach retirement, but to pursue the dual needs of income and asset preservation during retirement.

There is additional potential for fundamental, research-driven management in a series that increases the emphasis on higher yielding equity funds over time, however. Stocks in the dividend-paying universe can at times become expensive, as we have seen in recent years. Portfolio managers may account for these differences in valuations in their investment decisions. Managers of underlying funds also can seek to identify companies that are likely to grow their dividends in the future.
Dividend-oriented strategies have provided solid long-term returns with less volatility

As previously mentioned, the potential reduction of equity volatility along the glide path reflects the increased emphasis on income and reduced emphasis on higher beta stocks. To better understand the underlying mechanics of an equity glide path, it helps to look at the historical volatility and returns for income, growth and growth-and-income strategies. Although past results are not predictive of results in future periods, the chart below shows that equity-income funds have experienced strong returns and lower average volatility than their growth counterparts in rolling 20-year periods since the inception of the Lipper Equity Income Funds Index. Growth-and-income funds also have seen strong returns and lower average volatility relative to their growth counterparts in Lipper indexes. Importantly, this data set shows that emphasizing dividends hasn’t necessarily meant that investors sacrificed potential return relative to a purely growth strategy.

Income-oriented equity strategies: Strong returns with lower volatility

Average 20-year annualized return (%)
6 8 10 12 14 16

Average 20-year standard deviation
10 12 14 16 18

Lipper Growth & Income Funds Index
Lipper Equity Income Funds Index
Lipper Growth Funds Index

Average annualized returns and standard deviations for the rolling 20-year periods from December 31, 1970, to December 31, 2017. Past results are not predictive of results in future periods. Volatility is calculated at net asset value, using annualized standard deviation (based on monthly returns), a measure of how returns over time have varied from the mean; a lower number signifies lower volatility.

Sources: Capital Group, Thomson Reuters Lipper.
The “how” is as important as the “how much” in an equity glide path

Given expanding life spans due to medical advances, longevity risk has increased in importance for investors. This makes a meaningful allocation to equities essential, as equities have demonstrated a greater return potential over most long-term historical periods than bonds. Since 1926, U.S. stocks have outpaced U.S. corporate bonds in nearly all rolling 30-year periods, according to data from Ibbotson Associates.*

At the same time, target date fund managers need to be mindful of the increase in market risk that accompanies a higher allocation to equities. An approach that can help reduce the impact of this trade-off is to develop a Glide Path Within a Glide Path just for equity exposure. This Glide Path Within a Glide Path would gradually focus more on dividend-paying stocks and less on higher beta stocks near and after retirement. Plan sponsors should consider target date funds that reduce the overall allocation to equities as participants age, but at the same time shift the equity exposure to focus on historically less volatile strategies. To that end, plan sponsors should look at whether their target date series:

- increases the allocation to income-oriented equity funds over the glide path.
- increases the allocation to less volatile equity funds over the glide path.
- changes its investment style over the glide path to reduce the emphasis on growth and higher beta stocks over time.

The answer to these questions could make a significant difference in participants’ retirement readiness. Plan sponsors that want to recharacterize their equity exposure can do so by seeking a target date series that has a dynamic equity glide path. For custom target date funds, plan sponsors also can introduce less volatile dividend-oriented strategies in the glide path in the years around retirement.

*Based on monthly returns of Ibbotson Large Company Stocks Index and Ibbotson Long-Term Corporate Bonds Index, in U.S. dollars.