John Hancock Investment Management

Glide paths within the glide path

Nathan Thooft, CFA

Co-CIO, Multi-Asset Solutions Team, Head of Asset Allocation

Robert Sykes, CFA

Head of Asset Allocation, U.S., Senior Portfolio Manager

Geoff Kelley, CFA

Head of Strategic Asset Allocation, Senior Portfolio Manager

The allocation process for a target-date fund over time may go well beyond a single glide path that simply reduces equities, supplanting them with fixed income. Instead, there can be numerous glide paths involving subcategories of the primary debt and equity asset classes, along with glide paths for alternative asset classes. Each is intended to keep the participant's exposures appropriately balanced at different lifecycle stages. Understanding how these glide paths fit within a main glide path architecture provides a clearer view of how the overall process works from initiation to accumulation and through retirement.

Glide paths within the glide path: exploring the architecture of target-date funds

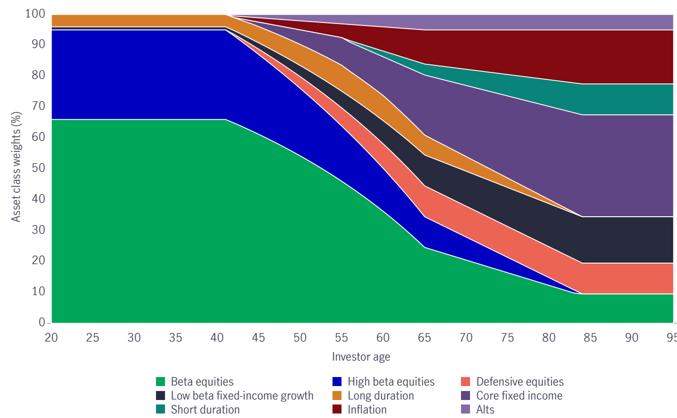
Google "glide path" and, once you've gotten past an airplane's descent and some logistics and industrial businesses, you're likely to land on the concept of the changing asset allocation of a target-date mutual fund. But if you think you've found pay dirt, many of the search results that seek to explain this type of glide path will begin and end with a stock/bond dichotomy: As you glide toward retirement, the target-date fund's stock allocation decreases while its exposure to bonds goes up.

This conventional and simplified view of an investing glide path conceals the significant roles played by sub-asset classes that target-date funds can use to calibrate risk and opportunity carefully en route to—and through—an investor's retirement. After all, stocks and bonds come in a wide spectrum of flavors, from speculative to defensive, and different parts of the spectrum are more relevant and useful at various degrees through the course of a participant's lifecycle.

For more sophisticated approaches, an overarching glide path contains a variety of component glide paths that determine a fund's exposures to a range of traditional and nontraditional equity and fixed-income securities. Alternative assets, as well, can be blended in varying degrees over time into target-date funds to offset correlations between core asset classes and provide a dynamically constituted measure of tail risk protection in the event of market downturns.

In this paper, we take a tour through this collection of glide paths that together form the basic architecture of our approach to target-date portfolio construction. To show the benefits of our approach, we first outline the asset class components and their benefits for investors at different life stages and then divide the major glide path into four discrete phases in which we describe the interplay of the asset class components. During the first (growth) and last (decumulation, with income and risk mitigation) of these phases, the strategic asset allocation mix remains constant, while during the intermediate de-risking phases, the blend changes over time to fit the investor's profile.

Glide path example



Source: Manulife Investment Management.
For illustrative purposes only. Not indicative of any fund.

Part I: the asset class components

Core and high beta equities: the keys to early-stage growth

It's standard practice for a target-date fund's glide path to assign its heaviest allocation to equities relative to fixed income when investors are in the early stages of their careers; however, there are different equity decisions that one can make during this period. For example, asset allocators may use a meaningful proportion of high beta equities such as mid caps, small caps, and emerging-market equities to help round out their allocation to traditional U.S. large-cap equities.

A significant high beta allocation comes with the understanding that young investors are typically not earning high salaries and their ability to contribute to their retirement funds may be limited. Perhaps, most importantly, the risk to these investors is relatively modest, given that they have virtually their entire working lives to potentially make up losses. In addition, drawdowns during retirement saving, especially in the early stages, may often accrue to the benefit of the saver, as they may provide the opportunity to accumulate more shares at lower levels.[1]

1 "Embracing drawdowns in target-date funds," Nathan W. Thooft, CFA, John Hancock Investment Management, 9/3/20.

Treasury STRIPS: as a line of defense

It's worth noting that the initial glide path allocation may include not only core and, to a lesser extent, high beta equities, but also a measure of long-dated U.S. Treasury Separate Trading of Registered Interest and Principal of Securities (STRIPS). These zero-coupon Treasuries provide a large amount of duration exposure (approximately 27 years) relative to a modestly sized allocation. This is because STRIPS provide no current income, allowing no opportunity to reinvest should rates rise, as the entire payoff comes at maturity. Managers blend these securities with equities in order to help provide a measure of defense in the case of a market downturn and flight to quality, which may result in a sharp decline in long-term interest rates and substantially boost the market value of STRIPS. Put another way, these securities tend to be negatively correlated with stocks.

Treasury STRIPS have been negatively correlated with equities

Trailing 36-month correlation: Intercontinental Exchange Bank of America U.S. Treasury Principal vs. S&P 500 Index

Source: FactSet, Bank of America Merrill Lynch, 12/31/20.
Past performance does not guarantee future results.

Defensive equities: cautious growth

Defensive equities typically exhibit betas well below 1, implying lower volatility relative to the overall equity market, and are generally less sensitive to the swings of the economy. During periods of market turmoil, defensive equities typically outperform the broader equity market. Examples of defensive equities include large, noncyclical companies whose products are in demand regardless of economic conditions, companies that pay above-average and/or growing dividends, or companies that demonstrate muted stock volatility properties. These individual strategies can be fused and constructed in a way where the outcome offers participation to the broader equity market, but does so in a way where the investor (participant) is likely less exposed to broad market drawdowns. Once introduced to a portfolio, defensive equities can play an increasingly important role.

Core fixed income: an essential retirement asset class

High-quality fixed-income securities are important in the middle—and essential at the end—of a target-date portfolio's glide path. The primary components are Treasuries and investment-grade corporate bonds, as well as mortgage-backed and asset-backed securities.

Low beta growth fixed income: yield and upside

This asset class consists primarily of high-yield bonds and emerging-market debt to maintain some growth potential along with income, which is consistent with the role played by defensive equities. Bank loans, which also may be used as short duration assets, may add to growth potential by providing exposure to credit-spread tightening.

Short duration assets: potential income and protection from rising rates

Short duration assets help maintain income while potentially reducing the exposure to higher interest rates that could endanger target-date funds during the income-producing stages. A target-date fund's short duration portfolio may also include short-dated investment-grade corporate notes and bank loans, whose interest rates float and therefore are intrinsically short duration. Bank loans tend to carry higher yields, as well, as these are generally issued as sub-investment-grade credits. This gives them, as mentioned above, an equity-like component in addition to short duration.

Potential inflation protection: real assets and TIPS

Real assets, although in liquid form, help fight the effect of inflation. These include global real estate investment trusts, infrastructure stocks, and natural resources equities. They also may provide a somewhat lower correlation to the broader market, offering certain benefits regardless of economic conditions. Other assets that may help guard against inflation include short duration Treasury Inflation-Protected Securities (TIPS).

Alternatives: helping reduce correlation and bringing other potential benefits

Alternatives aim for low or perhaps negative correlations to equities and fixed income. Major alternatives can include multistrategy global macro, global managed futures and systematic commodity trading advisor strategies, and global market-neutral currency portfolios. As the targeted correlations suggest, these investments may also provide some tail risk protection in times of market distress.

Part II: asset classes in action: putting the glide paths together

For each of the asset classes above, the portfolio management team develops a glide path that fits with the other asset classes to take the participant to and through retirement. These glide paths fit into four distinct phases of the participant's lifecycle with an ultimate objective of retirement readiness. The overarching aggregate glide path follows a course from a predominant equity weighting early to a concentration on fixed income at the end, but the individual asset classes all play roles in attempting to best prepare the participant for retirement by sufficiently accumulating wealth in the preretirement period. The objective is to help mitigate longevity risk subsequent to the participant's retirement date, focusing on long-term performance while helping manage the risk of potential drawdowns.

Phase I: the early build (initiation to age 42)

During this phase, the initial strategic allocations remain in place throughout. The objective in the portfolio's initial timeframe is to lay the foundation for substantially higher levels of savings buildup in the next phase. The portfolio consists almost entirely of equities of various types. There may be a substantial relative tilt toward high beta equities, including small caps, mid caps, and emerging-market stocks, constructed around traditional core U.S. equities (large caps). This tilt gives the investor the opportunity to build a potentially larger asset base for the primary accumulation years that come toward the end of this phase, by which time the investor's salary/wage income may have grown significantly.

The portfolio contains a small amount of tail risk protection in the form of Treasury STRIPS. This helps guard the portfolio from sharp market pullbacks that typically involve flights to quality. Despite the relatively small allocation to STRIPS, the position may offer substantial protection given its extremely long duration profile.

Phase II: de-risking and retirement red zone (age 43 to 65)

In this phase, the portfolio seeks to continue accumulating wealth, striving to increase the asset base from the first phase, but with a decreasing risk profile. Unlike in phase I, the strategic allocations change over the period, becoming more defensive over time. The portfolio increasingly moves into lower beta assets and diversification becomes key. Defensive stocks take space previously occupied by higher-growth equities. They may receive larger weights than in some broad-based equity indexes in order to maintain competitive equity exposure in a less volatile form. High-yield bonds and emerging-market debt, other lower beta assets with equity-like properties, may also move into the portfolio. The net effect is to try to keep a large but decreasing and less risky growth base as the aggressive initial equity allocations come down.

Core U.S. fixed income begins an increasingly important role, as it will for the remainder of the fund's life. Treasury STRIPS, which may have already been providing high-powered duration to help guard against a flight from risk assets to quality, first increase to potentially protect against sharp market pullbacks in a key wealth-building period. About halfway through this stretch, though, they start giving way to short duration fixed-income assets, which add income and balance the commitment to core fixed income.

Alternative investments may enter and grow, seeking low correlation with equities and possible tail risk protection when markets fall. With an eye to inflation, liquid investments based on tangible assets are likely to join and grow, along with TIPS.

Phase III: retirement begins and income withdrawals start (age 66 to 83)

The portfolio's equity holdings continue to decline, with defensive stocks taking an increasing piece of that area as the higher beta portion shrinks. It's still important to maintain growth exposure as longevity risk becomes a concern, but defensive stocks emphasize dividend yield and lower potential volatility.

With the general increase in longevity and the move from defined-benefit to defined-contribution plans, it makes sense to keep a reasonably significant allocation to risk assets longer in the glide path. Because many participants prefer to delay withdrawals if possible, maintaining a somewhat larger allocation to growth assets well into retirement is logical. A study by professors at Harvard, Dartmouth, and MIT from 1997 to 2010[2] of two age groups (60 to 69 and 72 to 85) showed that relatively small amounts of withdrawals occur before age 70, when the IRS's required minimum distributions (RMDs) took effect (the age is now 72).

At that point, the withdrawals jump but still only slightly exceed the minimum amounts. Savers appear focused on not outliving their assets. Notably, when the IRS suspended RMDs during the global financial crisis, presumably to support financial markets, savers stopped taking money out,[2] only resuming when the suspension was lifted. Major withdrawals beyond the required minimum generally begin to occur in the mid-to-late 80s likely in large part for medical reasons. Again, the preference to keep withdrawals relatively low until urgent needs occur argues in favor of keeping a meaningful incremental exposure to risk assets.

During this phase, the STRIPS allocation continues to give way to short duration assets as the portfolio's dominant risk begins to shift from risk assets to the duration associated with an increasing fixed-income allocation. Core fixed income's role grows as generating cash flow with high-quality assets becomes essential. To help mitigate against inflation risk, the portfolio may add more inflation protection, generally as short-dated U.S. TIPS.

Phase IV: steady-state landing (age 84 on)

As with the initial phase, the strategic weightings don't change here. Income and low volatility are paramount, and the heaviest weighting at this point is investment-grade fixed income. A relatively small equity allocation remains, along with short duration assets with some growth potential. Inflation-sensitive holdings may also play a significant role.

Conclusion: a multi-legged relay race

The individual glide paths participate in a sort of relay race, not necessarily stopping but passing along part of the baton to other asset classes. This keeps exposure changes gradual, giving the participant appropriately diversified exposures at different stages throughout the lifecycle. Using more granular asset classes such as defensive equities and short duration fixed-income controls risk, maintaining equity exposure more cautiously and adding to income while avoiding excess duration. Alternatives and potential inflation protection add to the mix when needed. Recognizing that target-date funds can go far beyond a single glide path goes a long way toward understanding the power and flexibility of the funds.

2 The Drawdown of Personal Retirement Assets: Husbanding or Squandering," J. Poterba, Steven F. Venti, and D. Wise, January 2013, National Bureau of Economic Research, funded by grants from the Social Security Administration and the National Institute on Aging.

Beta measures the sensitivity of the fund to its benchmark. The beta of the market (as represented by the benchmark) is 1.00. Accordingly, a fund with a 1.10 beta is expected to have 10% more volatility than the market.

ICE BofA Long US Treasury Principal STRIPS Index is an unmanaged index comprised of long maturity Separate Trading of Registered Interest and Principal of Securities (STRIPS) representing the final principal payment of U.S. Treasury bonds.

The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index.