Complements, not substitutes: Together, managed accounts and target date funds improve retirement plan outcomes

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Plan sponsors and consultants commonly benchmark managed accounts against target date funds. While both are professionally managed portfolios, comparing the two implies they are effectively substitutes, where a participant would be equally likely to use either option (or at least be indifferent between the two). However, our research shows that this is not the case and that managed accounts and target date funds are, in fact, complementary options, and together, contribute to improved overall retirement plan health and participant outcomes.

Our research also shows that including managed accounts in a defined contribution plan results in a significant increase in the percentage of participants who end up in professionally managed solution portfolios, which we define as either target date fund or managed account portfolios. An analysis of plans that do and don't offer managed accounts also shows that the availability of managed accounts helps reduce the proportion of participants self-directing their accounts.

Similar yet different: Participants can benefit from managed accounts and target date funds

Both managed accounts and target date funds share a similar starting point in that they use a participant's years-to-retirement to construct age-appropriate asset allocations. They also both help overcome participant inertia when offered as a plan's Qualified Default Investment Alternative (QDIA) and automatically rebalance to maintain targeted asset allocations. There are also some features that differentiate managed accounts.

Personalization: Managed accounts offer participants with different methods of personalization—passive and active—throughout their lifecycle. Passive personalization does not require participant action and leverages available plan data obtained through the recordkeeper. Through active personalization, participants can update additional factors that may influence portfolio construction.

Persistent strategy: Participants using managed accounts typically stay invested in the service. Research shows that during 2020, participants tended to stay invested in managed accounts and were less likely to change investment strategies compared to target date fund investors.[1]

Methodology: This study uses a data set from Empower Retirement that includes 2,371,165 participants across 17,740 plans as of June 30, 2021. Participants were segmented according to three investment strategies for the purpose of this analysis: managed accounts, target date funds (100% of portfolio), and do-it-yourself (DIY) investors. Only plans not using managed accounts as the default investment were included.

1 Empower Retirement, "Market Volatility and the Value of Personalized Investment Solutions," July 2020.

Managed accounts and target date funds are complements

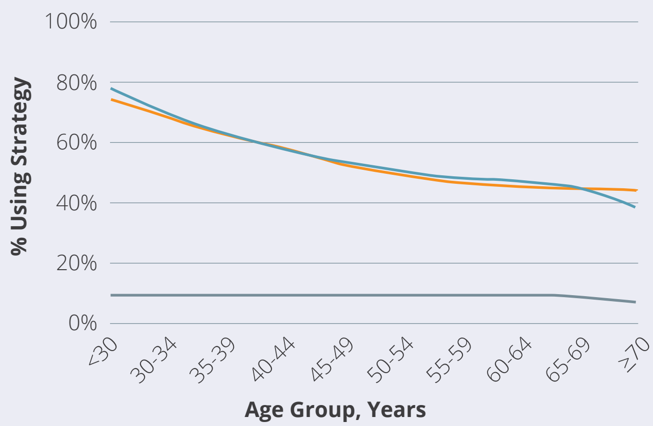
Managed accounts and target date funds share similar attributes, such as being multi-asset vehicles that adjust their allocations as participants approach retirement. Through professional management, they both simplify portfolio diversification, help mitigate potential behavior biases and take investor emotions out of the decision-making process.

There is evidence showing that investors do not consider the two products to be substitutes. In other words, absent one of these options, participants will not typically choose the other option and may end up self-directing their accounts, which may lead to poorer investment decisions.

An analysis of participants' target date fund usage when managed accounts are and are not present in retirement plans supports this. Panel A illustrates that participant usage of target date funds remains virtually the same across age groups whether or not a managed account service is offered, while usage of managed accounts is fairly consistent across age groups. Panel B goes one step further and shows more participants (mainly from the DIY group) are invested in professionally managed solutions when managed accounts are offered to participants in the plan.

Investment strategies adoption by age group

Panel A:
Participants using various investment strategies by age group



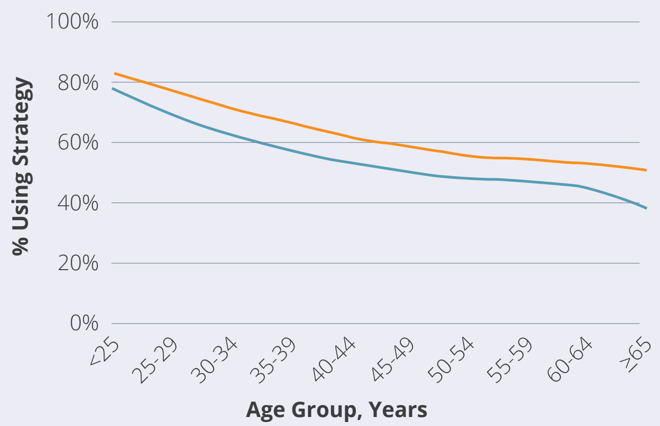
Target date fund usage, no managed accounts

Target date fund usage, offer managed accounts

Managed accounts usage (when available)

Source: Empower Retirement

Panel B:
Participants using professionally managed retirement solutions by age and whether the DC plan offers managed accounts



Professionally managed solutions, no managed accounts

Professionally managed solutions, offer managed accounts

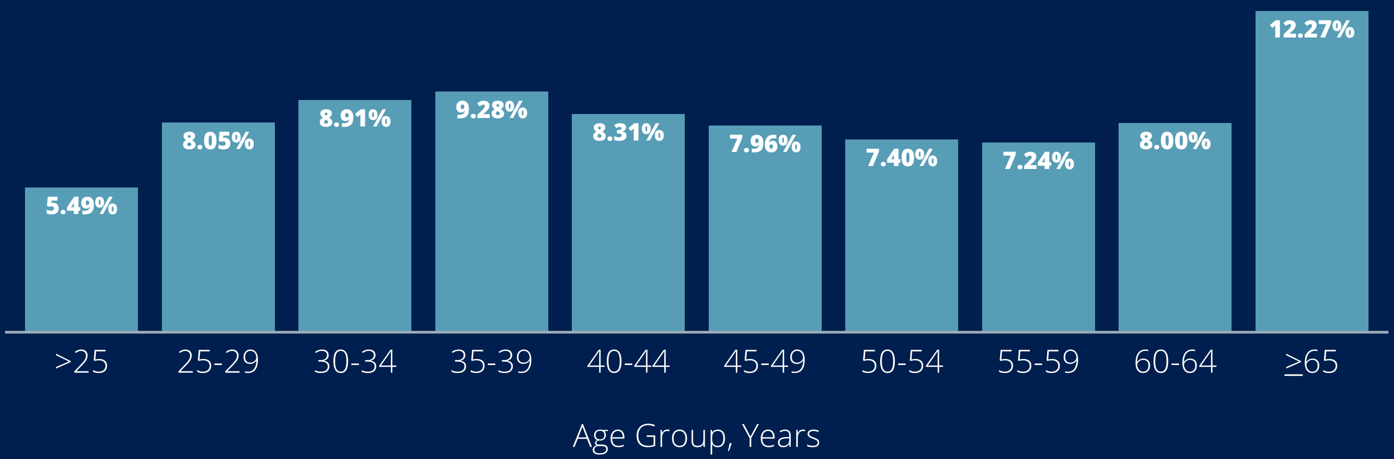
Source: Empower Retirement

What's most important to understand from this analysis is that participants do not consider managed accounts to be substitutes for target date funds. In other words, without managed accounts as an option, a large percentage of participants would likely self-direct rather than opt for a target date fund.

Capture rate: Measuring the increase in professional management[2]

By comparing plans that do and don't offer managed accounts, we can estimate what percentage of plan participants end up in managed accounts and would likely have ended up self-directing absent the service. We find that among the participants who end up in managed accounts, roughly 80% **("the capture rate")** would end up self-directing their accounts if managed accounts were not available.

Increase in use of professionally managed solutions when managed accounts are available by age group



Source: Empower Retirement

2 The "capture rate" for managed accounts is calculated by first looking at the percentage difference of participants using professionally managed solutions in plans that offer target date funds when a managed account is and isn't offered to participants. This difference is then divided by the percentage of participants using a managed accounts option to obtain the "capture rate" or the percentage of participants who would have ended up self-directing.

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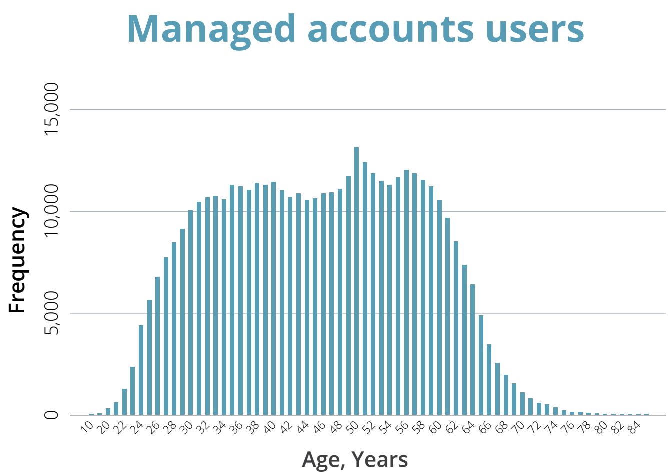
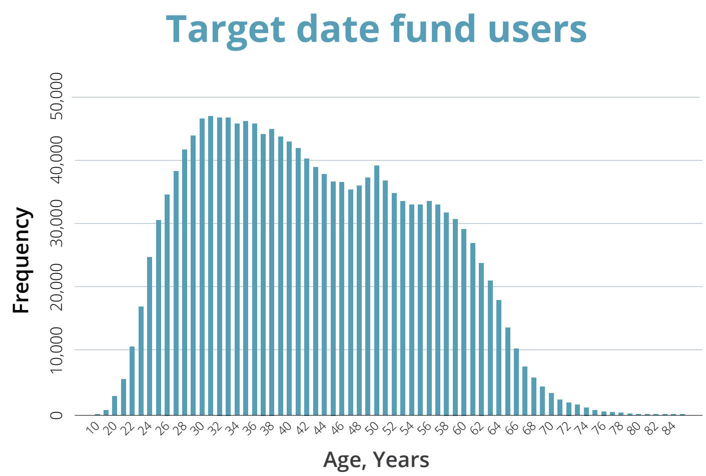
Understanding participant preferences

Participants of all ages use managed accounts and target date funds, but there are key distinctions between users of each investment option. Relatively speaking, participants who use target date funds tend to be younger with lower balances and income, while participants who use managed accounts tend to skew towards older individuals with higher balances and income. According to our Probit regression analysis,[3] age and income differences are especially notable and significant in determining the likelihood of adoption between the two. For example, target date funds would generally be more attractive for younger participants with lower incomes, while managed accounts are a better fit for the opposite.

Age distribution difference between managed accounts and target date fund users



Average Balance: $103K
Average Income: $79K



Average Balance: $61K
Average Income: $70K

Source: Empower Retirement

This is especially important when considering the impact of investment styles on participants' retirement planning. Given older workers are closer to retirement and have higher balances, their investment and planning decisions tend to be more consequential or have a larger immediate impact than those of younger investors. Offering managed accounts to participants could help shift self-directing participants to professionally managed solutions and could benefit some of the approximately 50% of self-directing participants who are 65 years or older.[4]

Optimizing plan investment options

Professionally managed solutions such as target date funds and managed accounts may contribute to better plan outcomes through diversification, professional management, and helping overcome behavior biases—also known as taking participant emotion out of investing. However, when evaluating these two options, there is a temptation to compare them directly, implying they are substitutes, not complements, for participants.

And while we find evidence that managed accounts have historically outperformed target date funds on a risk-adjusted basis after fees,[5] consistent with past research on the topic, these are apples-to-oranges comparisons. As we noted earlier, managed accounts tailor a participant's portfolio through passive and active personalization, directly influencing its total return. Ultimately, managed accounts complement target date funds, increase participant usage of professionally managed solutions, and reduce participant self-direction.

3 A Probit model estimates the probability a value will fall into one of the two possible outcomes.
4 Empower Retirement data.
5 On a one-year, three-year, and five-year annualized geometric rate of return average basis. Primarily as of March 31, 2021, as well as during the 2020 calendar year.