September 2022

A happy medium: Blending active and passive in target date funds

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Highlights

Target date funds (TDFs) have traditionally consisted of either actively or passively managed portfolios. But in recent years, TDFs that blend both styles have grown in popularity, offering many benefits.

- Blended TDFs that include both active and passive underlying strategies are aligned with the common DC plan practice of offering both styles of funds in standalone investment lineups.
- A mix of investment styles allows for improved potential returns at a lower cost than fully active TDFs.
- Blended TDFs tend to offer broader asset class diversification, averaging twice the number of underlying categories than the largest passive TDFs.

Blended target date funds are gaining steam

Since the passage of the Pension Protection Act in 2006, target date funds have experienced explosive growth, moving from the fringes of the defined contribution (DC) world to the mainstream. For most DC plan sponsors, TDFs are now the qualified default investment alternative of choice.[1] For many plan participants, the set-it-and-forget-it aspect of TDFs is quite attractive, compared with the time-consuming task of constructing a portfolio from standalone investments in the plan lineup.

> TDFs that combine active and passive strategies have become increasingly popular, chosen by more than a third of DC plans.[2]

All of this means that selecting a TDF suite is one of the most important decisions a plan sponsor must make. But it's not as straightforward as it may seem. Not only must plan sponsors consider the performance and associated fees of the TDFs, but they must also weigh the management style of the underlying strategies: active, passive, or a combination of the two.

Traditionally, most TDFs have consisted of either active or passive strategies, with asset flows trending in favor of passive TDFs. But more recently, we have seen a shift toward blended TDFs that take a "best of both worlds" approach. As of 2021, 37% of DC plans used blended TDFs, up from 23% in 2018.[2]

Why should DC plan sponsors consider using blended TDFs rather than passive-only or active-only alternatives? Here are three reasons.

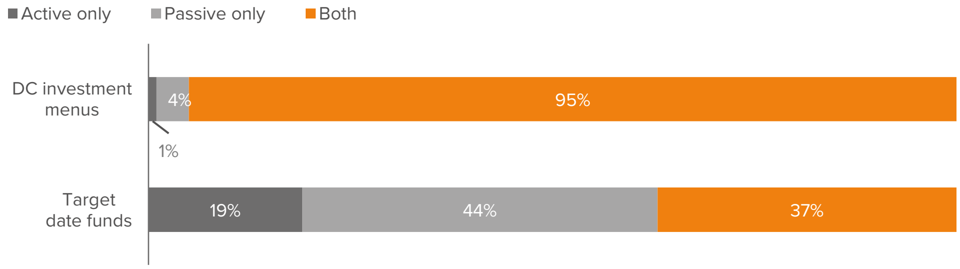
1. Aligning with defined contribution plan design best practices

A DC plan's investment philosophy and approach to its standalone investment lineup can serve as a guide for determining the most appropriate TDF management style. According to Callan's latest DC Trends Survey, most plan sponsors include a combination of active and passive funds in their investment lineups (Figure 1). This approach allows for a wider array of asset classes and risk/return scenarios, which helps the plan sponsor fulfill its fiduciary obligation. The same logic can—and, in our view, should—extend to TDFs; we agree that both styles have a place in retirement portfolios.

[1] PlanSponsor.com: A Target for Scrutiny.
[2] Callan 2022 Defined Contribution Trends Survey.

Blended TDFs better mirror the approach of standalone DC plan options, most of which provide access to both active and passive funds.

Figure 1: Most DC plans include both active and passive options—why shouldn't TDFs?



Source: Callan 2022 Defined Contribution Trends Survey (March 1, 2022). Based on responses from 101 plan sponsors, 74% of which had more than $1B in assets. DC investment menu data excludes "no response."

2. Improving potential returns at lower cost

The debate about active versus passive rages on—with supporters of the latter citing the many successes in passive equity products. But what works in one asset class may not be as successful in another.

Fixed income, for example, is hard to replicate with passive index funds due to the sheer size of the investment universe. Despite the lower management costs of passive products, active fixed income funds have outperformed the index over the long term (net of fees), especially among higher-ranked managers (Figure 2). (For a deeper dive on this topic, see Voya Investment Management: Passive Equity Arguments Fail in Fixed Income.)

A blended TDF can add value by employing active strategies in less efficient asset classes (such as fixed income or non-traditional investments), where the success rate in enhancing returns has been higher. At the same time, using cost-effective passive strategies in more efficient areas of the market (such as U.S. large- and mid-cap equity) helps reduce the overall cost of the portfolio. This gives participants exposure to higher potential excess returns at a lower cost than what most fully active TDFs charge.

Blended TDFs may use active where active works well and passive where the cost savings pay off.

Figure 2: Some asset classes tend to be better suited to active management

Morningstar peer group **Benchmark**	10Y annualized return (%)	Morningstar 10Y ranking	Active management success
US Large Blend **S&P 500 TR**	12.96	17	Lower
US Mid Blend **Russell Mid Cap TR**	11.29	23	
Foreign Large Blend **MSCI EAFE NR**	5.40	45	
Emerging Markets **MSCI Emerging Markets NR**	3.06	50	
Global Bond **Bloomberg Global Aggregate Bond TR**	0.11	52	
US Small Blend **Russell 2000 TR**	9.35	65	
Intermediate Bond **Bloomberg US Aggregate Bond TR**	1.54	66	
Short-Term Bond **Bloomberg US Gov't/Credit 1–3Y TR**	1.01	84	Higher

As of 06/30/22. Source: Morningstar, Voya Investment Management. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Rankings represent each index's ranking relative to the designated Morningstar peer group. **Past performance is no guarantee of future results.**

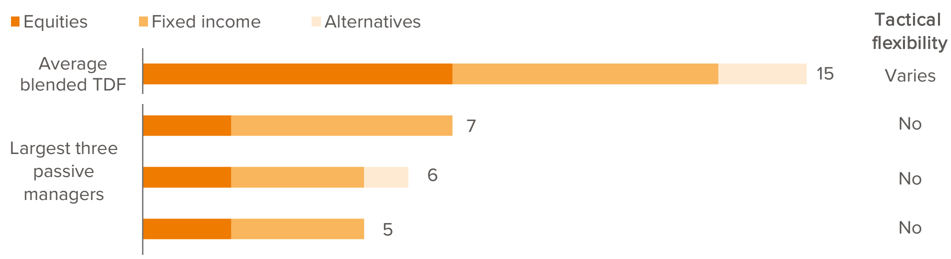
Many blended TDFs access a wider range of opportunities in hard-to-index asset classes, potentially enhancing diversification.

3. Providing greater diversification

Passive TDFs tend to consist of fewer asset classes than active and blended TDFs. This limitation is particularly true in fixed income and non-traditional or alternative investments, which, as noted above, can be difficult or costly to replicate passively. Choosing a passive TDF that excludes these markets is, in itself, an active fiduciary decision.

A review of holdings data for the largest passive and blended TDFs shows that the largest three passive TDF suites include very few asset classes, as represented by Morningstar categories. By contrast, blended TDFs include more than twice as many distinct asset classes, on average, as well as a broader set of diversified strategies (Figure 3). In our view, diversification is an essential component of long-term investment success, and this informs our blended approach to TDFs.

Figure 3: Blended TDFs may offer broader access to diversifying asset classes



As of 6/30/22. Source: Morningstar Direct. Passive managers include Vanguard, BlackRock and Fidelity. Average of the nine largest blended TDFs. Asset class count based on Morningstar categories observed, as well as non-categorized money market funds (excluding individual securities, cash and other holdings). Includes target date fund suites considered to have a blended approach (no more than 85% invested in either active or passive investments).

A manager's portfolio construction decisions may have a much larger impact on participant outcomes than the marginal cost savings of so-called "passive" TDFs.

There's no such thing as a truly passive TDF

Despite what the naming convention suggests, managers of passive TDFs still must make active decisions, such as:

- Glide path construction
- "To retirement" versus "through retirement" landing points
- Asset allocation
- Asset class breadth
- Tactical or static asset allocation approach
- Portfolio construction and management

These active decisions—regardless of the management style of the underlying strategies—can have a much larger impact on performance than fee differences (Figure 4). Among the 2025 TDFs with a 10-year record, the best and worst performers were separated by 450 basis points (bp), while the average fee differential between blended and passive TDFs was just 20 bp.

Figure 4: TDF design choices have had a far bigger impact than fees

The fee difference between blended and passive TDFs is just 20 bp…

TDF style	Average mgmt. fee
Active	0.42%
Blended	0.30%
Passive	0.10%

…whereas other active decisions (such as equity allocation) have led to more significant differences in long-term outcomes.

2025 TDFs	1Y net return	10Y net return	Equity allocation
Highest	–6.1%	8.0%	58%
Lowest	–16.1%	3.5%	19%[1]
Difference	10.0%	4.5%	39%

As of 8/31/22. Source: Morningstar, Voya Investment Management. Left exhibit based on a subset of the largest underlying mutual funds' lowest-fee share class. Right exhibit includes all 131 funds in Morningstar's Target Date 2025 open-end peer group; performance is based on annualized net-of-fee returns. **Past performance does not guarantee future results.**
[1] Excludes one outlier TDF with 0% exposure to equities.

Meeting in the middle

The process of selecting the most appropriate TDF suite for a DC plan requires a thorough understanding of the product and how it will align with the plan's objectives, philosophy and participant needs. Deciding on the investment style is just one component of the process, and both active and passive approaches to TDFs can play a role. In our view, however, a blended approach offers the best of both worlds to plan sponsors and participants.

To learn more about the Voya Target Date Blend Series, visit our website.

Principal risks

There is no guarantee that any investment option will achieve its stated objective. Principal value fluctuates and there is no guarantee of value at any time, including the target date.

The "target date" is the approximate date when an investor plans to start withdrawing their money. When their target date is reached, they may have more or less than the original amount invested. For each target date portfolio, until the day prior to its target date, the portfolio will seek to provide total returns consistent with an asset allocation targeted for an investor who is retiring in approximately each portfolio's designated target year. On the target date, the portfolio will seek to provide a combination of total return and stability of principal.

Stocks are more volatile than bonds, and portfolios with a higher concentration of stocks are more likely to experience greater fluctuations in value than portfolios with a higher concentration in bonds. Foreign stocks and small- and mid-cap stocks may be more volatile than large-cap stocks. Investing in bonds also entails credit risk and interest rate risk. Generally, investors with longer timeframes can consider assuming more risk in their investment portfolio.

As with any portfolio, you could lose money on your investment in a Voya Target Date Blend Series. Although asset allocation seeks to optimize returns given various levels of risk tolerance, you still may lose money and experience volatility. Market and asset class performance and the assumptions used form the asset allocations for the Voya Target Date Blend Series. There is risk that you could achieve better returns in an underlying portfolio or other portfolios representing a single asset class than in the Voya Target Date Blend Series. Important factors to consider when planning for retirement include your expected expenses, sources of income, and available assets.

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