FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

77K Street, NE Washington, DC 20002

MEMORANDUM TO BOARD MEMBERS KENNEDY, BILYEU, JONES, MCCRAY, AND JASIEN

FROM: Ravindra Deo Ravindra Deo
Acting Executive Director

DATE: May 23, 2017

SUBJ: Lifecycle Funds "through retirement" vs "to retirement" study by Mercer Investment Consulting; summary and recommendations

INTRODUCTION:

This memorandum summarizes key points of a recently conducted study by Mercer Investment Consulting (Mercer) of the impact on Thrift Savings Plan (TSP) participant outcomes if a "through retirement" approach were adopted for the Lifecycle Funds (L Funds). In addition, the FRTIB offers a recommendation in response to Mercer's analysis and recommendation and provides suggestions and rationale for considering "through retirement" in the future.

BACKGROUND:

Mercer conducted the Federal Retirement Thrift Investment Board's (FRTIB) Annual L Funds Asset Allocation Review (Review) in 2016 and presented the results during open session in the November 29, 2016 Board Meeting. The consultant recommended considering the potential benefits to adding more equity along the L Fund glide paths in the context of greater risk, but, added that those benefits would be only very minor. We concurred with Mercer's observations about the very low marginal benefit to changing to a riskier posture and recommended to the Executive Director (ED) that no changes be made to the L Fund glide paths at that time. In addition, year-over-year shifts in demographic data warranted additional attention in order to justify glide path changes to support such small projected gains. There was also information suggesting that replacement ratios on average would be expected to support good retirement outcomes for participants with the current L Funds asset allocation and additional risk may not be desirable. Historical returns for the L Funds appeared favorable relative to a target date fund survey universe presented by Mercer.

We suggested that future Reviews might yield different results and that it would be prudent to consider these as circumstances warrant, particularly as demographic data comes to light that may be more conclusive.

Board members requested that the ED commission a follow-on study to determine the impact on participant outcomes that a change to a “through retirement” approach for the L Funds would have.

COMMENTARY:

The FRTIB engaged Mercer to conduct a follow-on study to determine the impact that changing to a “through retirement” approach would have on TSP participant financial and risk outcomes for the L Funds, using capital market assumptions and FERS employee demographic data from the most recent Review for comparative purposes. Mercer was directed to define “to retirement” and “through retirement” and to provide information on current market practices in target date funds (TDFs). It was also asked to discuss potential benefits and drawbacks and to make a recommendation as to whether or not the TSP should adopt a “through retirement” approach.

For purposes of this study, “through retirement” was defined as a design in which glide path “asset allocation continues to roll down from equity to fixed income in the early postretirement years” while in “to retirement,” the “asset allocation rolls down to the target maturity year, then asset allocation remains constant postretirement.” The TSP L Funds follow a “to retirement” approach to target date fund investing wherein the glide paths associated with each reach their terminal points at the target retirement and payout commencement years associated with the L Funds respectively.

Mercer provided information indicating broad usage of the “through retirement” approach by TDFs in its universe of survey participants. Out of 35 TDFs, 27 employ a “through retirement” approach and eight adhere to a “to retirement” approach. “Through retirement” TDFs in the Mercer survey universe reach their glide paths’ terminal points from five to as much as 30 years past their designated retirement years. Mercer demonstrated that the TSP L Funds exhibit a conservative investment profile relative to the Mercer TDF survey universe overall.

Mercer tested “through retirement” outcomes for the L Funds by proposing several alternative glide paths to the current glide paths, reverting to past equity/fixed income combinations of five, ten, and fifteen years along each of the L Funds glide paths. This would lead to the Funds’ glide path terminal points extending by the same numbers of years. It tested a fourth alternative glide path that reached its terminal point ten years past retirement and was modified to reduce its equity/fixed income profile much sooner than the other ten year alternative. This was intended to reduce preretirement volatility of participant account values and investment returns relative to the other “through retirement” alternatives.

Analytical results were supportive of a “through retirement” approach. Greater allocation to equity across the L Funds’ glide paths for longer periods of time yielded better financial outcomes as measured by real account balances at retirement and pre-retirement income replacement ratios. Longevity measures such as probability of depletion of TSP account balances by certain ages and median expected drawdown ages were also more favorable.

Risk outcomes during the two years leading to retirement were made worse by these same increased equity allocations. Mercer highlighted increased probabilities of declining account values and increased likelihood of investment loss during the final two years leading to retirement. These measures worsened with increased equity allocations.

Summarizing, in order of shifting the glide paths five, ten, and fifteen years “through retirement,” financial outcomes generally improved and risk outcomes generally deteriorated, the exception being the modified alternative.

The result was that Mercer recommended using a ten year “through retirement” approach after considering both risk/reward tradeoffs and data evidencing that many TSP participants likely remain invested to age 70. In particular, it suggested the modified approach that reduced preretirement volatility should be applied to the L 2030, 2040, and 2050 Funds. It recommended that the L 2020 Fund be left unchanged because of its being very near its terminal point of July 2020 already and likely factored in to existing individual participant plans. Similarly, Mercer suggested that the L Income Fund remain unchanged.

Mercer also provided an analysis of changes in current glide path outcomes if the retirement age assumption were simply changed to age 62 from age 61. The results revealed a dramatic increase in the current glide path financial outcomes without taking on any additional equity exposure. In fact, Mercer’s work pointed out that not only was the current case age 62 median scenario far better than the current case age 61 median scenario but also it was better than all of the age 61 median financial and risk outputs across the current case and the modified alternative. In summary, participants retiring at age 62 instead of age 61, by many measures, are better off than they could be made through many of the examined glide path alternatives that have increased growth investment allocations applied to an age 61 retirement. This analysis was driven by data showing that the average retirement age of TSP participants has been increasing from 61 to 62.

CONCLUSION:

The FRTIB's opinion is that the glide paths should not be changed to reflect a "through retirement" approach at this time.

1. There is improvement in going from "to retirement" to "through retirement" L Funds in terms of replacement ratios and expected longevity. The improvement is relatively small, however. Remarkably, volatility is significantly higher than comparable measures for the current case. With benefits being very small and the chance for poor returns and even losses being much higher just before the point of retirement, we are concerned with the potential impact on the sentiment of participants about to retire.

2. We recommend continuing with the current approach and analyzing if the change should be made again at a later date for the following reasons:

    a. The current analysis relies on demographics from the entire participant base. For instance, there are participants that invest purely in the G Fund; that affects the average deferral rate and the average account balance. They affect the glide path for the participants that actually use the L Funds. We now have the ability to base the demographic data on participants that use the L Funds, which will create a more accurate representation of their characteristics, and which will in turn affect the glide path outcomes.

    b. Our participants are changing over time. As Social Security creates disincentives to retire earlier, we expect our participants average retirement age to increase. We are now seeing the migration from an average retirement age of 61 to 62, and we could see this continue to increase slowly over time. The change in retirement age of one year had a significant impact on replacement ratios and longevity without taking on additional equity. If the retirement age continues to increase, it could have a large impact on the glide paths.

    c. We are entering a period of large change in the L Fund participant base with the implementation of "Blended Retirement." We cannot yet quantify the impact Blended will have on the L Fund demographics, but we expect it to be significant, particularly for the L 2050 Fund. It seems imprudent to make such a significant change before we see the impact of Blended.

3. We would therefore like to suggest that we include the impact of "to retirement" vs "through retirement" in the next few years' annual L Fund studies starting with this year. We will restrict the demographic data to L Fund participants (over 1.4 million currently), and in 2 years (2019 L Funds study) we should be able to see the impact of Blended.