Retirement Isn't Passive; Target Date Strategies Shouldn't Be Either

Active versus passive debate misses the mark, in our view.

May 2022

KEY INSIGHTS

- Actively managed building blocks within target date portfolios provide diversification potential that may not be possible to achieve with passive components.
- We believe skilled active management has the potential to generate meaningful outperformance, improving investors' ability to reach retirement objectives.
- Fiduciary duties do not require plan sponsors to select passive vehicles. An array of options, including actively managed funds, can be appropriate offerings.

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Given the fiduciary pressures on plan sponsors to hold down costs and make prudent investment decisions, it's not surprising that many defined contribution (DC) plan sponsors, investment professionals, and consultants may regard a passively managed strategy as the easy choice when selecting a target date offering.

However, we believe a bias toward target date offerings that only invest in passive building blocks may reflect a fundamental misunderstanding of the legal and regulatory standards governing fiduciary investment decisions. As a result, we fear that many DC plan sponsors could be missing potential opportunities to enhance diversification and improve long-term retirement results for their participants through active management.

Our argument starts with the simple observation that there actually is no such thing as a passive target date strategy.

Every target date provider must make a threshold decision about the underlying asset classes that will be included in the portfolio, and must set the glide path—in particular, the split between equity and fixed income assets—that those allocations will follow over time.

It is true that passive portfolios typically are less expensive than their actively managed counterparts given that they don't incur the costs of researching, selecting, and trading potentially attractive investment opportunities. We also recognize that some passive investments can provide efficient capital market exposure in specific sectors while also delivering significant cost reductions.

Selecting a target date strategy entirely on the basis of cost can produce suboptimal investment results, in our view.

- Active management can provide potential diversification opportunities that may not be available to passive

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portfolios. Some asset classes or sectors are more difficult to track using passive benchmarks and/or may offer a less attractive risk/reward profile.

- Using only passive components forecloses potential opportunities to generate excess returns, net of fees. While not every active manager can outperform a passive benchmark, we believe it is possible to identify skilled managers who can add value over the long term. We believe T. Rowe Price's long-term track record documents the potential value that skilled active management can add to a target date portfolio.

- Excluding actively managed components may give plan sponsors a false sense of security about satisfying their fiduciary responsibilities. The use of passive strategies does not in itself satisfy fiduciary standards such as those set by the Employee Retirement Income Security Act (ERISA). Sponsors can and have been challenged in court over their passive offerings.

The Potential Limits of Passive Fixed Income

Because there are a number of asset classes that investors can't, or might not want to, invest in passively, passive target date strategies may provide only limited coverage of some key market areas that we believe are vital to pursuing long-term retirement outcomes.

A more diversified approach, in our view, can help investors better navigate a range of market environments. Accordingly, an overemphasis on keeping costs low by employing only passive underlying components could sacrifice diversification potential that can benefit target date investors over the long term.[1]

The use of passive investment components can be especially problematic in the fixed income arena. Within some fixed income sectors, it isn't practical—or in some cases even possible—to hold all the constituent securities in the most common market indexes, making it difficult to replicate benchmark performance without potentially significant tracking error.

The Bloomberg Global Aggregate Bond Index, for example, includes over 27,800 distinct securities from multiple sectors, often with multiple issuances for any one name.[2] Many of these bonds are issued in relatively limited quantities and trade infrequently in the secondary market, making the index difficult to replicate given the number of securities involved and the potential transaction costs.

Replicating benchmark exposures also may result in unintended or undesired risk concentrations. In the high yield corporate bond sector, for example, the largest issues by par value account for a disproportionate share of the ICE BofA U.S. High Yield Constrained Index. Investors who simply reproduce those same weights in their passive portfolios may face higher risk of loss from potential defaults or downgrades in the largest issues.

Credit risk is the primary risk associated with high yield investing; active management allows for credit research that may help mitigate certain default risks.

For these reasons, there are relatively few passively managed high yield bond products available to investors, and target date providers who include only passive components in their asset allocation mix are more likely to exclude high yield or other "non-core" fixed income sectors altogether. As a result, their portfolios may be more concentrated in core sectors, such as U.S. Treasuries and investment-grade U.S. corporate bonds, that are likely to carry higher duration risk and that historically have offered lower expected returns.

[1] Diversification cannot assure a profit or protect against loss in a declining market.
[2] As of December 31, 2021. Data from Bloomberg Index Services Limited (see Additional Disclosures).

> Maintaining diversified exposure is especially critical in today's fixed income markets, in our view.

Maintaining diversified exposure is especially critical in today's fixed income markets, in our view. A 40-year bull market in bonds, including two periods of quantitative easing by the U.S. Federal Reserve, pushed yields to historical lows. However, more recently, stronger economic growth and rising inflationary pressures have pushed interest rates higher. As a result, the Bloomberg U.S. Aggregate Bond Index posted negative returns in 2021 and the first quarter of 2022, confirming that core bonds don't always successfully fill their traditional role of diversifying equity risk while providing positive returns.

Under these conditions, we believe that returns to bond holders from accepting duration risk are likely to remain below the historical averages for some time, requiring retirement investors to look outside the market sectors represented in the Bloomberg U.S. Aggregate Bond Index to pursue their long-term income objectives.

Reflecting these considerations, T. Rowe Price emphasizes a diversified approach to fixed income investing in our target date funds. We include allocations to high yield bonds, floating rate bank loans, and emerging market debt in an effort to enhance long-term diversification. In addition, our target date funds include a dynamic global bond strategy that seeks to provide generally uncorrelated returns at risk levels similar to a core bond benchmark. The strategy seeks to diversify against equity risk even when U.S. interest rates are rising.

Many, if not most, of the fixed income diversification enhancements we have incorporated in our target date asset allocation mix would be inefficient or impossible to replicate using only passive components.

Seeking Opportunities in Equity

The magnitude of the potential for outperformance also can make equities an attractive arena for active management in target date strategies. Specifically, we believe that the growth and value styles offer opportunities for active management to add value in both U.S. and international developed markets, even after investment costs are taken into account. In our own target date funds, we maintain a sizable actively managed allocation to U.S. large-cap equities throughout the glide path, because we believe the magnitude of potential value added outweighs the lower cost of a passive alternative.

Emerging market (EM) equities also present potential opportunities for active equity components in target date strategies, in our view. Emerging equity markets generally are regarded as relatively inefficient compared with the major developed markets, meaning that investors with an informational advantage may be able to identify potentially undervalued companies or industries. This can play to strengths of active portfolio managers with access to in-depth fundamental analysis—such as the expertise provided by T. Rowe Price's global research platform.

In addition, some EM equity indexes are also heavily weighted toward specific sectors and/or country markets. As a result, an entirely passive approach that tracks these indexes may produce portfolios with undesired risk concentrations.

Finally, T. Rowe Price's target date funds also include dedicated allocations to real asset equities, such as natural resource, precious metals, and real estate stocks. These allocations enhance diversification potential and provide a hedge against unexpectedly high rates of inflation. However, the universe of passive indexes does not offer adequate benchmarks for real asset equity allocations, in our view.

Keys to Active Success

We believe strongly that a skilled investing approach, backed by experienced management teams and a well-resourced global research platform,

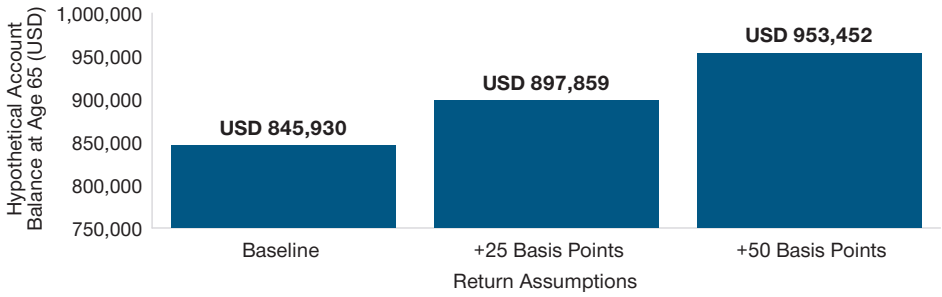
can add value over longer-term time horizons. Compounded over time, even small return improvements can make a significant difference in ending portfolio values (Figure 1), potentially extending a target date portfolio's ability to support postretirement spending (Figure 2).

Looking at the historical active performance of our target date funds, we see a high level of consistency. Within our Retirement Funds, active management (based on security selection in the underlying components plus tactical allocation at the strategy level) added an average of 48 basis points in annualized excess returns, net of fees, over rolling 10-year periods (rolled monthly) from fund inceptions through December 31, 2021.[3]

At T. Rowe Price, we attribute our historically strong track record of target date performance to the quality of our strategic investing approach. Our managers average 22 years of investment experience.[4] That means our portfolio managers have experienced multiple market cycles and are less likely to overreact to short-term market fluctuations. Our process is collaborative, which we believe produces better, more robust, investment ideas. Lastly, our culture is investment-led, and focused on delivering strong relative performance and outstanding service to our clients.

Even Modest Return Improvements Can Impact Long-Term Results

(Fig. 1) Value of a Hypothetical Retirement Portfolio at Age 65*



For Illustrative Purposes only. Actual investment results will vary, perhaps significantly.

*Values shown are based on a hypothetical investor who starts with a USD 0 balance and a USD 30,000 salary at age 25 and then invests 9% of salary each year. Salary increases were assumed to equal 3% annually. The baseline scenario assumes a 7% annual return prior to retirement at age 65, and a 5% return thereafter. The initial postretirement annual withdrawal was set at 50% of ending salary (USD 48,931) and was assumed to increase 3% each year thereafter until portfolio exhaustion. To demonstrate the impact of a 25 basis point (0.25%) and a 50 basis point (0.50%) increase in returns, the assumed preretirement returns were raised to 7.25% and 7.50%, respectively, and postretirement returns were increased to 5.25% and 5.5%. **Demographic assumptions, contributions, and investment returns are shown for illustrative purposes only and are not intended to provide any assurance or promise of actual returns and outcomes.** See Methodology Appendix for additional important information.

Source: T. Rowe Price.

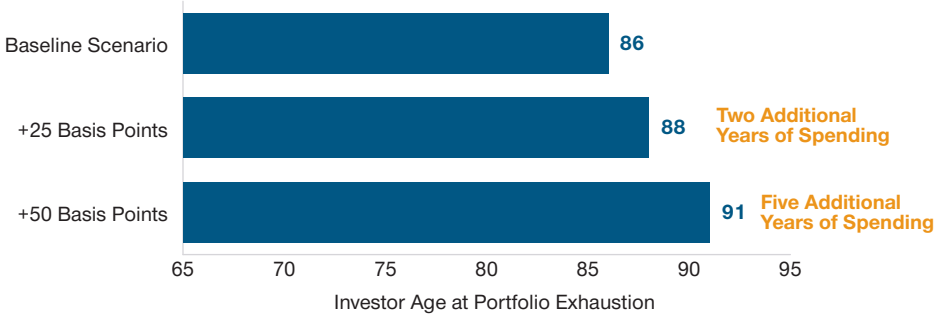
[3] **Performance data quoted represents past performance and is not a reliable indicator of future performance.** We examined the performance of all of our Retirement Funds (RFs) that had at least 10-year track records as of December 31, 2021, a total of 11 funds. To provide a summary of the effectiveness of T. Rowe Price's target date process, we calculated performance averages for all 11 RFs for tactical allocation and security selection. Returns were calculated relative to each underlying fund's asset class, sector, or style benchmark. Returns were then aggregated to show the total excess returns for each RF. Excess returns from tactical allocation and security selection were calculated for each rolling monthly period and then averaged across all the periods in each time frame. To provide a high-level summary, a time-weighted performance average was then calculated for the 11 Retirement Funds. See Appendix for additional detail on the calculation of tactical allocation and security selection. The complete study methodology for the 11 funds included in our analysis can be found at **www.troweprice.com**. **See performance page for standardized performance of the Retirement Funds.**

[4] As of December 31, 2021.

> We believe T. Rowe Price's track record of success has demonstrated the value of including active components in target date portfolios.

Potential Excess Returns From Active Management May Extend Portfolio Longevity

(Fig. 2) Age of a Hypothetical Retirement Investor at Time of Portfolio Exhaustion*



For Illustrative Purposes only. Actual investment results will vary, perhaps significantly.

*Based on the same hypothetical assumptions shown in Figure 1. **Demographic assumptions, contributions, and investment returns are shown for illustrative purposes only and are not intended to provide any assurance or promise of actual returns and outcomes.** See Methodology Appendix for additional important information.

Source: T. Rowe Price.

Given our outlook for relatively subdued returns in core fixed income sectors, and equity market valuations that still appear historically stretched in absolute terms, the additional sources of return that active management potentially provides could become even more important drivers of retirement outcomes going forward. In our view, target date funds are an ideal place to utilize active management because of the long-term investment horizons inherent in their design.

We believe T. Rowe Price's track record of success has demonstrated the value of including active components in target date portfolios. Although we recognize that for some investors these benefits must be balanced with other considerations, such as cost, our view is that active management has a vital role to play in most asset allocations—a role that is only likely to become more important if longer-term market conditions remain challenging.

Fiduciary Considerations

Some plan sponsors may be under the impression that adopting an entirely passive approach to target date investing can help insulate them from regulatory actions and/or lawsuits challenging their fiduciary conduct. This is a common misperception.

In reality, ERISA does not take sides in the active versus passive debate. While fiduciary standards require DC plan sponsors to exercise due diligence in their investment choices, and to ensure that plan costs are "reasonable," these requirements are not automatically satisfied by selecting the lowest-cost investment option or by simply seeking to replicate the returns on a particular market index.

Indeed, ERISA standards require DC plan sponsors to consider both the costs and the potential benefits to participants of their investment offerings, and it would be prudent to take into account the specific characteristics and expected retirement income needs of their plan populations. Or, as one recent analysis puts it:

> *"Consistent with the role that participant choice plays in defined contribution plans, courts have acknowledged that fiduciaries*

may appropriately provide plan participants with an array of options, including actively managed funds."[5]

The critical point to understand is that fiduciary conduct is judged based on the process by which investments are selected and monitored, not on investment outcomes. For plan sponsors, this highlights the need to follow an informed, well-structured approach to the evaluation and selection of target date strategies, including glide path design, strategic asset allocation, the potential role of tactical allocation, and the use of active or passive underlying components.

Documenting the target date evaluation process is critical, as is verifying that the provider(s) selected continue to exercise prudent judgment in their ongoing management of the target date offering.

Conclusions

We believe strongly that active management can play a critical, valuable role within target date strategies, by improving excess return potential and enhancing portfolio diversification in asset classes or markets where an entirely passive management approach is either unpractical or is likely to produce excessive risk concentrations and/or lead to suboptimal performance results.

However, we also recognize that for some investors, including DC plan sponsors, these benefits must be weighed against other considerations, such as cost. The appropriate balance between active and passive components in a target date strategy will depend on each investor's specific circumstances, taking into account factors such as return objectives, risk tolerance, plan demographics, and the expected potential for active management to add value in specific markets or sectors.

Finally, the most important consideration for DC plan sponsors is to ensure that decisions regarding their target date offerings—including the choice of active or passive components—are based exclusively and solely on the best interests of plan participants, not the sponsor's own desire to minimize potential legal liability.

As a target date provider, T. Rowe Price seeks to improve outcomes for our target date clients at multiple levels—via glide path design, long-term diversification, tactical asset allocation, and our approach to active management. Our target date process is rigorous, backed by in-depth research and analysis, and carefully documented at every step. We believe the value added can meaningfully enhance retirement outcomes for plan participants and other investors.

For more information on the target date products and services available to our clients, please contact T. Rowe Price.

[5] Alison V. Douglass and Christina Hennecken, Selecting, Evaluating, and Monitoring Investments in DC Plans: A Legal Perspective, Goodwin Procter LLP, March 2021. See Additional Disclosures.

Important Information

Standardized Performance

Annualized total returns for periods ended March 31, 2022

Fund (Inception Date)	Gross Expense Ratio*	1 Year	3 Years	5 Years	10 Years
Retirement 2005 Fund (NAV) (2/27/2004)	**0.49%**	1.14%	7.39%	6.44%	6.01%
S&P Target Date Retirement Income Index		0.32	5.44	5.08	4.70
Retirement 2010 Fund (NAV) (9/30/2002)	**0.49**	1.39	7.94	6.92	6.55
S&P Target Date 2010 Index		1.14	6.39	5.81	5.51
Retirement 2015 Fund (NAV) (2/27/2004)	**0.51**	1.66	8.50	7.50	7.28
S&P Target Date 2015 Index		1.90	7.06	6.40	6.24
Retirement 2020 Fund (NAV) (9/30/2002)	**0.53**	1.89	9.18	8.23	8.05
S&P Target Date 2020 Index		2.14	7.40	6.78	6.80
Retirement 2025 Fund (NAV) (2/27/2004)	**0.55**	2.16	10.14	9.06	8.82
S&P Target Date 2025 Index		2.88	8.56	7.71	7.56
Retirement 2030 Fund (NAV) (9/30/2002)	**0.58**	2.45	11.07	9.85	9.51
S&P Target Date 2030 Index		3.70	9.65	8.56	8.28
Retirement 2035 Fund (NAV) (2/27/2004)	**0.59**	2.69	11.90	10.50	10.05
S&P Target Date 2035 Index		4.73	10.90	9.50	8.99
Retirement 2040 Fund (NAV) (9/30/2002)	**0.60**	2.92	12.63	11.09	10.48
S&P Target Date 2040 Index		5.48	11.78	10.15	9.50
Retirement 2045 Fund (NAV) (5/31/2005)	**0.62**	3.17	13.13	11.43	10.67
S&P Target Date 2045 Index		5.96	12.30	10.51	9.83
Retirement 2050 Fund (NAV) (12/29/2006)	**0.63**	3.25	13.17	11.46	10.68
S&P Target Date 2050 Index		6.16	12.56	10.72	10.08
Retirement 2055 Fund (NAV) (12/29/2006)	**0.64**	3.21	13.12	11.41	10.66
S&P Target Date 2055 Index		6.24	12.65	10.80	10.25

*Expense ratios are as of the most recent prospectus.
Sources: Standard & Poor's (see Additional Disclosures) and T. Rowe Price.

Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or loss when you sell your shares. Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions. To obtain the most recent month-end performance, please visit our website or contact a T. Rowe Price representative at 1-800-225-5132.

Methodology Appendix

Figures 1 and 2:
The results shown are hypothetical, do not reflect actual investment results, and are not a guarantee of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Results do not include the impact of fees, expenses, or taxes. Results have been adjusted to reflect the reinvestment of dividend and capital gains. Actual returns may differ significantly from the results shown. The demographic assumptions, returns, and ending balances are shown for illustrative purposes only and are not intended to provide any assurance or promise of actual returns and outcomes.

Value added by tactical allocation and security selection for the 11 Retirement Funds:
To account for the differing longevity of each RF, all performance averages were time-weighted—the results are based on the percentage of the total performance periods in each time frame provided by each RF. To quantify the value added by T. Rowe Price's tactical allocation process, returns were calculated using each underlying fund's style-specific benchmark. For each vintage, each underlying fund's actual weight was multiplied by its style-specific benchmark return to generate positioning inclusive of tactical allocation changes. These positions were then subtracted from each respective underlying fund's fixed strategic asset allocation weight, multiplied by the style-specific benchmark return. The result is the difference between actual positioning, including tactical decisions and implementation, versus strategic asset allocation positioning. To quantify the value added by security selection, excess returns—net of fees and other costs—were calculated for the underlying funds in each RF relative to each underlying fund's style-specific benchmark. Fund-level returns were then aggregated for each RF. A basis point is 0.01 percentage point. **Past performance is not a reliable indicator of future results.**

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Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

The principal value of the Retirement Funds is not guaranteed at any time, including at or after the target date, which is the approximate year an investor plans to retire (assumed to be age 65) and likely stop making new investments in the fund. If an investor plans to retire significantly earlier or later than age 65, the funds may not be an appropriate investment even if the investor is retiring on or near the target date. The funds' allocations among a broad range of underlying T. Rowe Price stock and bond funds will change over time. The funds emphasize potential capital appreciation during the early phases of retirement asset accumulation, balance the need for appreciation with the need for income as retirement approaches, and focus on supporting an income stream over a long-term postretirement withdrawal horizon. The funds are not designed for a lump-sum redemption at the target date and do not guarantee a particular level of income. The funds maintain a substantial allocation to equities both prior to and after the target date, which can result in greater volatility over shorter time horizons.

All investments are subject to risk, including the possible loss of principal. When valuations fall and market and economic conditions change it is possible for both actively and passively managed investments to lose value.

Derivatives may be riskier or more volatile than other types of investments because they are generally more sensitive to changes in market or economic conditions. Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in high-yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets.

Past performance is not a reliable indicator of future performance. All charts and tables are shown for illustrative purposes only.

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