ROUND TABLE
WEALTH MANAGEMENT

INVESTING IN INDEX & TARGET DATE FUNDS

A CLOSER LOOK FOR THE SMART INVESTOR

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The rise in popularity of investing in passive index funds has occurred for a number of reasons—simplicity, low cost and a "can't beat the market" perspective. As a result, passive index funds have gained a significant market share compared to actively managed counterparts. According to the Federal Reserve Bank of Boston: "As of March 2020, passive funds accounted for 41 percent of combined U.S. mutual fund and ETF assets under management (AUM), up from 3% in 1995 and 14% in 2005."

A similar investment trend has emerged with the adoption of Target Date Funds. For those new to Target Date Funds, these investment strategies provide a simplified, passive investment approach (often structured as a mutual fund or ETF) consisting of an asset allocation mix that becomes more conservative over time as the predetermined target date approaches. In concept, this asset allocation glidepath should track that of an individual investor whose asset allocation should become more conservative with age.

However, like many simple solutions to complex problems (e.g., portfolio management), an understanding of these passive investment options is imperative to know the best use of them to enhance portfolio performance.

This article:

- *Provides an overview of passive index investments and target date funds; and*
- *Details key aspects such as index construction, performance implications, and their impact on portfolio management.*

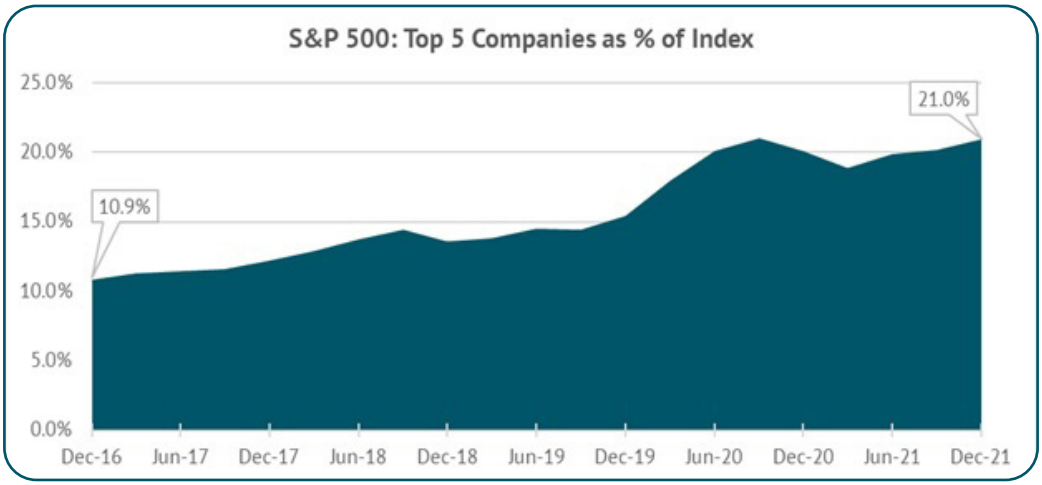
Equity Markets (S&P 500 Index)

Index Construction

The S&P 500 Index is constructed of the 500 largest publicly traded companies in the United States and weighted according to market capitalization (total dollar market value of a company's outstanding shares of stock). As a result, the S&P 500 Index captures approximately 80% of the available U.S. market capitalization. Due to the market cap weighting methodology, companies with larger market caps have a more substantial presence and performance impact on the index over smaller companies in the index. In theory, this should mirror the relative impact these companies would have on the U.S. economy.

Performance Implications

The current composition of the S&P 500 Index is highly concentrated in a few stocks—more than in prior years.



Source: Morningstar Direct As of Dec. 31, 2021

For example, the top five constituents—Apple, Microsoft, Amazon, Facebook, and Alphabet—now account for roughly 21% of the index, whereas six years prior they only accounted for 11%.[1] These top five companies accounted for 27% of the S&P 500 2021 gain of 26.9%. The technology sector now accounts for roughly 29% of the index.[1]

The index concentration also has implications in terms of investment style, creating a tilt toward growth style investing that is detailed in the style box.

Finally, the bottom 250 companies account for just 12% of the index's total market cap.[1] Many of these companies employ a greater number of people than any of the top holdings in the information technology sector. Therefore, it would be misleading to assume that the S&P 500 Index is a meaningful representation of the broader U.S. economy.

Equity Style Box - S&P 500

Portfolio Date: 12/31/2021

	Value	Blend	Growth
Large	19.9	31.1	32.6
Mid	5.8	7.6	2.9
Small	0.1	0.0	0.0

Source: Morningstar Direct As of Dec. 31, 2021.

Portfolio Management

The underlying factor exposures of an index's constituents can have a material impact on the risk and return behavior of the index. Therefore, for an index with a top-heavy composition like the S&P 500, what ultimately matters is the relative performance of the stocks with the highest weightings. Throughout a market cycle, the relative performance of these top constituents will dictate the overall level of performance of the index. For instance, given the technology and growth-focused nature of the S&P 500's current constituents, the index performance will be heavily influenced—for better or worse—by the performance of this sector.

The current level of concentration in the S&P 500 is a historical outlier that presents potential risks to investors. The possibility of harsh regulatory action against the leading U.S. technology companies or a sustained uptick in inflation could be catalysts that reduce valuations of the largest holdings in the index. An investor should recognize that company and sector weightings in the index reflect current valuations as determined by the market and not the true economic impact or broad exposure to the U.S. economy.

Using the S&P 500 index as part of a core holding in a portfolio is appropriate as it provides adequate diversification and exposure to the large cap segment of the U.S. equity market. An investor should, however, be aware of the underlying holdings that drive performance. In addition to investing in an S&P 500 index fund, complementary strategies can be used to balance out a portfolio and align with market views. Strategies could include adding more diversification across market capitalization (e.g., small/mid-cap companies), style tilts (e.g., growth vs. value), and sector weightings (e.g., Financials, Energy, etc.) to reflect one's outlook on the economy and equity growth prospects more accurately.

[1]Source: Morningstar Direct

Fixed Income Markets—Bloomberg U.S. Aggregate Bond Index ("the Agg")

Index Construction

Due to the substantial amount of government debt in our economy, most broad market bond indexes (or funds that track an index) tend to be substantially overweight government debt—U.S. treasuries, mortgage-backed securities and/or municipal debt. The Agg is comprised of 39% U.S. treasuries. If you include debt issued by government agencies and mortgage-backed securities, the total government exposure rises to almost 70%.

Performance Implications

Given that government debt financing is often of a long-term nature, these bonds tend to have long-term maturities and durations. Bond maturity is the future date when the bond is paid off. Bond duration is a measure of how sensitive a bond price is to a change in interest rates. When interest rates rise, the value of a bond decreases. In general, the longer the maturity and duration, the higher the risk of a bond price decreasing in a rising rate environment, such as the one we are in now.

Bond yields will also vary by the credit quality of the issuer. U.S. Government bonds—having the highest credit quality—will have the lowest yields. And given their outsized presence in broad market bond indexes, this suppresses the overall yield of an index.

Portfolio Management

The differences between a "set it and forget it" bond index strategy versus one that is more reflective of current economic conditions can be seen in the following table. We compare the Vanguard Total Bond Market index (VBTLX), the Barclays Aggregate Bond Index (AGG) and a sample of a managed bond portfolio that might be appropriate for a moderate risk investor. The managed bond portfolio has shorter maturities and durations, therefore the value of the portfolio should be less sensitive to interest rate changes in a rising rate environment.

	Vanguard (VBTLX)	Barclays Aggregate (AGG)	Moderate Risk Managed
Average Maturity	8.8 years	8.5 years	4.9 years
Average Duration	6.8 years	6.6 years	3.6 years

Source: Morningstar Direct. As of Nov. 30, 2021.

A managed bond strategy can adjust for maturity, duration, credit quality and a changing economic outlook. Passive indexes do not make these adjustments. As with equity indexes, understanding the underlying components of a bond index is key to formulating a complementary bond strategy that reflects the investor's view of fixed income opportunities.

Target Date Funds

Target Date Funds address an investor's capital needs at some future date—hence the name "target date." The date most often used is an investor's retirement date. The asset allocation—and risk—becomes more conservative as the target date is approached. Target date funds are often default categories in 401K plans to assure that employees are fully invested in appropriate vehicles.

Fund Construction

The typical Target Date Fund adheres to an asset allocation approach that follows a risk reducing glide path, becoming more conservative as the retirement date approaches and continues into retirement. The following table demonstrates Vanguard's approach to Target Date Fund investing, highlighting the varying levels of risk based on the "target date" and the corresponding asset class exposures.

	Target Date 2060 (VTTSX)	Target Date 2025 (VTTVX)
Years until retirement	38	3
Total Stock Market (U.S. Equity)	55.10%	34.20%
Total International Stock (Non-U.S. Equity)	35.20%	22.80%
Total Bond (U.S. Fixed Income)	6.90%	30.20%
Total International Bond (Non-U.S. Fixed Income)	2.80%	12.80%

Performance Implications

One of the drawbacks to Target Date Funds is that asset allocations are predetermined and change very slowly over time. Thus, Target Date Funds are unlikely to reflect the optimal investment opportunities at any given time. For example, the Vanguard Target Date 2060 Fund listed above would be appropriate for an investor with about 40 years until retirement. The current asset allocation exhibits an International Stock allocation of about 35%. This predetermined allocation does not account for current market conditions or a portfolio manager's outlook, which may contrast with the static target weighting scheme. If, for example, an investor's view is that U.S. equity markets will be stronger than international markets, they may favor a 20% international allocation, which is a material underweight exposure relative to the Target Date 2060 Fund.

Alternatively, the Total Stock Market fund holds about 8.3% of its assets in smaller companies, or about 4.6% of the Target Date 2060 (as the holdings are based upon market cap). This same investor's view might be that small and mid-cap equities will provide strong performance in a current market cycle and would want to hold closer to 15% in small and mid-cap equities—an overweight to the Target Date 2060 Fund.

Portfolio Management

The Target Date approach of "set it and forget it" comes with the opportunity cost of not being able to tailor an investment strategy to account for current market conditions. Some 401K plans offer many Target Date Fund options, but very few other investment options such as mutual funds or ETFs. For this investor, understanding the underlying asset classes of the Target Date fund and investing in other funds (through IRAs and taxable accounts) will allow them to position the portfolio differently than these "locked in" positions in order to produce an overall portfolio that is more in line with the investor's outlook.

Conclusion

Blindly following "simple" investment strategies can lead to unintended and suboptimal results. It is important for every investor to truly understand what is "under the hood" of each investment strategy so that smart portfolio decisions can be made. At Round Table Wealth Management, we manage our client portfolios with a mix of passive index strategies and actively managed investments. Importantly, we coordinate the underlying holdings of each to achieve the desired results.

Please contact your Round Table Wealth Management Advisor for further information.