

OPINION

Nam, Chaewoo

**Korea's Target Date Fund (TDF) Market:
Current Status and Improvements**

Korea has a great expectation that the introduction of default options to the retirement pension scheme would boost the growth of the Target Date Fund (TDF) market. The management structure of TDFs with a life cycle-based portfolio rebalancing mechanism best suits the implementation of default options. Such growth of the TDF market has been similarly observed in the US and other economies with a developed default option scheme. Korea has seen its TDF market post a two-fold increase every year since 2016, a growth trend that is expected to accelerate after default options are fully adopted. Given the characteristics of the default option scheme and TDFs, herding towards the top major funds is likely to intensify in Korea, as is the case with the US. Under the circumstances, what is needed are specific standards for establishing a default option, regulations of pension asset management, and the reinforced disclosure system.

In the Korean version of the default option scheme, healthy competition in the market is essential for TDFs to act as a critical tool for pension asset management. To this end, ordinary employees should be able to conduct an objective comparison between various investment products that are offered in the form of default options. As for a TDF that is the fund of funds, it is important for pension providers to disclose glide path-related information and details of sub-funds incorporated for realizing the glide path. Such disclosure makes it possible to fully take into account Korea's employment conditions and household asset portfolios that are quite different from those of the US. In this respect, Korea's pension providers should develop their own TDFs or actively customize the TDFs imported from overseas markets.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* Ph.D., Research Fellow, Fund&Pension Department, Tel: 82-2-3771-0827, E-mail: zeuss@kcmi.re.kr

Introduction

A default option will be introduced to the retirement pension scheme. More precisely, discretionary default options would be mandated in DC plans and the IRP system under the name of prior investment management designation.¹⁾ In line with this, retirement pension providers should select multiple products from the prior investment management designation methods²⁾ prescribed in the Act on the Guarantee of Employees' Retirement Benefits (hereinafter referred to as the Act) and then seek preliminary review and approval from the Ministry and Employment and Labor before presenting the products to plan sponsors. A plan sponsor needs to reflect default options offered by pension providers in its by-laws after obtaining the consent of the labor representative. Then, employees would receive default option-related information from pension providers and designate one product as their default option. Unless otherwise instructed by an employee until four weeks after his or her plan asset management designation period expires, the pension provider notifies the employee that the pre-determined default option would be applied, and the management of plan assets would be initiated according to the notified default option after the passage of two weeks.

Despite structural limitations of a discretionary default option including principal-protected products, the proportion of investment-linked products is anticipated to rise to some extent in the management of retirement pension assets after the introduction of default options to Korea. Although it is not exactly the same default option scheme as the one offered by economies with a developed pension scheme, Korea would provide a default option as part of qualified investment instruments equipped with reasonable diversification and appropriate risk control tools. This would give practical benefits to many DC plan members who agree on the need for boosting returns on retirement pension assets and complain of difficulties in selecting

1) A default option refers to an automatic enrollment pension scheme offered to DC plan members who cannot give a specific investment instruction. However, the Korean version of the default option scheme—expected to take effect from July 2022 after the passage of the relevant law at the end of 2021—has been designed in the form of representative fund designation by allowing plan members to select in advance from a wide pool of products offered by pension providers. The implementation of the default option scheme is an obligation, not a choice and thus, a plan sponsor should reflect matters concerning prior investment management designation in by-laws after obtaining the consent of the labor representative within one year after the act is enforced.

2) This means the Qualified Default Investment Alternatives (QDIA) that are prescribed by the 2006 Pension Protection Act as a condition for providing employers immunity from any loss related to default options. The revised Act on the Guarantee of Employees' Retirement Benefits (the Act) describes the TDF (Target Date Fund), the BF (Balanced Fund), the SVF (Stable Value Fund), and the SOC Fund, as an exemplary method of prior investment management designation. Furthermore, the Act allows pension providers to offer principal-protected products in the form of deposits and installment savings as default options.

investment products. In this regard, what is especially essential in Korea's default option scheme is pension providers' management capability to establish and present to plan sponsors efficient Qualified Default Investment Alternatives (QDIA). This would determine whether the default option scheme that Korea has managed to introduce is a success or failure.

The role of TDFs in the pension market

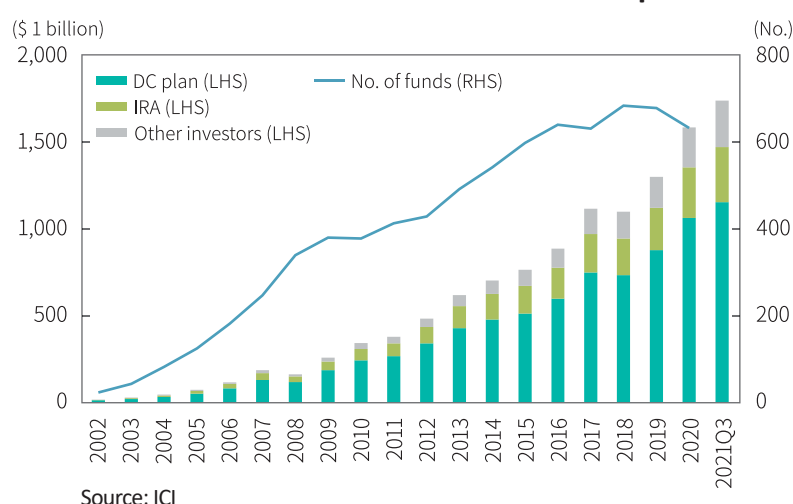
Retirement pension products offered as default options can be roughly classified into the Target Date Fund (TDF) and the Balanced Fund (BF). A TDF is designed to rebalance risky assets as an investor moves closer to the target date under the assumption that the investor's risk tolerance is in proportion to the remaining investment horizon before retirement. The rebalancing mechanism inherent in TDFs is called an asset allocation curve or a glide path. On the other hand, a BF is referred to as the Target Risk Fund (TRF) in that it aims to hit a specific risk target through a mix of stocks and bonds. A BF has the benefit of allowing investors to build an investment portfolio that meets individual risk appetite, while BF investors need to regularly figure out their own risk appetite based on which they should actively seek rebalancing of portfolio risks. For these reasons, a TDF seems to be the investment instrument that best suits the purpose and requirements of default options. In the long-term management of retirement pension assets, continuous rebalancing, as well as the initial composition of portfolios, is the most challenging and important factor. Thus, effective default options are necessary to allow independent experts to build diversified investment portfolios fit for individuals' risk appetite and regularly conduct an automatic adjustment on behalf of employees who hardly care about plan asset management. This is a structural benefit of the age-based glide path embedded in TDFs, which is observed in economies that have an advanced retirement pension scheme with effective default options.

As of the end of September 2021, the net asset of TDFs in the US amounts to \$1.741 trillion, taking up 6.7% of the entire mutual fund market. The growth trend of the TDF market is in line with a steep rise in assets of retirement pension plans such as the 401(k) plan.³⁾ This has been triggered by the 2006 revision to the Pension Protection Act (PPA) that essentially aims to implement the auto enrollment and provide plan sponsors immunity from any default option-related loss. As illustrated in Figure 1, the TDF market of the US has surged by an annual average

3) The proportion of TDFs accounted for less than 1% of the total mutual fund market before the 2006 revision to the Pension Protection Act came into effect.

of 20% until recently since the 2018 stock market slowdown. Given that the number of TDF products decreased to 633 from 685 over the same period, it appears that the size of funds has risen and a larger amount of capital has been channeled to high-quality funds. About 66% of TDFs' net assets (\$1.154 trillion) are placed in DC plan accounts, and if IRA assets are included, 85% of the total TDFs has come from retirement pension plans. It is notable that TDF products are structured to comprehensively entrust fund managers with all investment decisions including the rebalancing mechanism. Considering the fund structure, Korea is also expected to see retirement pension assets managed through TDFs being funneled into the top, high-quality funds.

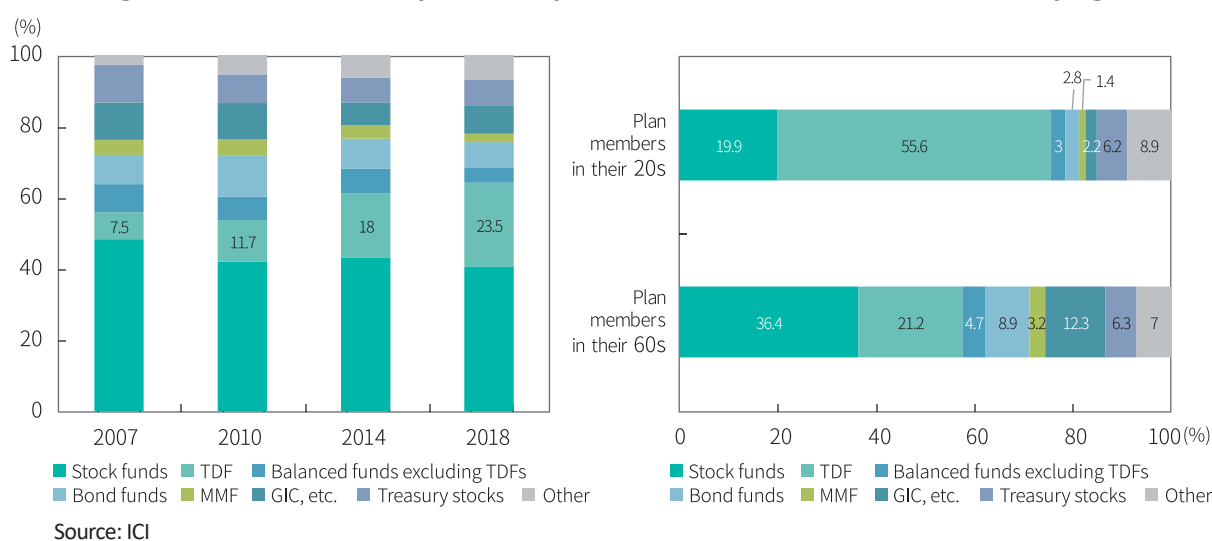
Figure 1. Net assets of TDFs and TDF investor composition in the US



In the US, individuals actively engage in investment in financial assets and DC plans allowing employees to give a direct investment instruction have become prevalent. In terms of plan asset management, the US has recently seen a rise in indirect investment products with the same structure as TDFs. In this respect, it is meaningful to take a look at the composition of the 401(k), the representative retirement pension plan of the US. Although stock funds still account for more than 40% of its assets, the proportion of TDFs has steadily increased since the revision to the PPA to reach 24% as of 2018. In particular, it is noteworthy that those in their 20s who have newly joined the retirement pension scheme have to manage their plan assets for 30 years or longer and 56% of them have selected TDFs as an investment product for their plan assets. Also notable is that plan holders in their 60s whose retirement draws nearer still have a high proportion of stock funds at more than 36%. TDFs have a structure that can be

universally applied to the annuity payment phase as well as the plan asset accumulation phase.⁴⁾ However, regarding long-term TDFs that actively incorporate risky assets such as stocks, pension providers should build an appropriate portfolio and secure a relevant track record to gain a competitive edge.

Figure 2. The US 401(k) plan: composition of funds and classification by age



Korea's TDF market

In Korea, the TDF market has posted a two-fold increase over the previous year, reaching KRW 10. 8731 trillion in the value of net assets as of the end of 2021. The TDF market has doubled every year since TDFs were fully introduced to Korea in 2016. This growth trend is expected to continue well into this year as the adoption of default options could accelerate the management of pension assets through TDFs. Out of the total net assets of TDFs, the proportion of pension assets stood at around 25% in 2016, which has recently climbed to 70%. Furthermore, Table 1 shows that out of retirement pension funds that make investments in the form of collective investment securities (funds), the proportion of TDFs has gone up every year to reach 23.6% as of the end of 2021. This implies that TDFs designed to ensure automatic rebalancing along the glide path would gain a competitive edge both as default options and ordinary DC plans allowing employees to directly give an investment instruction.

4) Generally, the TDF glide path is designed to ensure the efficient accumulation of pension assets during the employment period. But if annuity payment, instead of lump-sum pension payment, becomes commonplace, the TDF glide path could be broadly applied to annuities designed for the monthly payment of retirement benefits.

Table 1. Current status of Korea's TDF market

(Unit : KRW 100 million)

	2016	2017	2018	2019	2020	2021
No. of pension providers	3	6	8	10	12	16
No. of funds	70	361	467	641	921	1,057
TDF (established)	661	6,727	13,707	28,799	41,790	80,754
TDF (net asset value)	672	7,424	13,740	33,242	52,108	108,731
Proportion of retirement pension plans ¹⁾	24.7%	39.5%	49.6%	46.2%	59.3%	70.2%
Retirement pension funds (established)	91,186	109,998	123,643	150,769	173,225	238,446
Retirement pension funds (net asset value)	91,014	116,516	123,873	161,862	206,488	303,218
TDFs for retirement pension plans (established)	163	2,654	6,715	13,271	24,713	56,328
TDFs for retirement pension plans (net asset value)	166	2,932	6,808	15,351	30,860	76,313
Proportion of TDFs ²⁾	0.2%	2.4%	5.4%	8.8%	14.3%	23.6%
Return of TDFs ³⁾		12.3%	-7.6%	16.5%	9.9%	10.4%

Note: 1) Proportion of retirement pension plans in TDFs in terms of the net asset value

2) Proportion of TDFs in retirement pension plans in terms of the sum established for plans

3) Annual average returns weighted by net assets, compiled regarding the funds managed for one year since their establishment

Source: FundDoctor Pro (ZEROIN), Korea Financial Investment Association, Financial Supervisory Service

When annual average returns are calculated based on each fund's return weighted by the value of net assets, TDFs deliver solid returns of more than 10%, except for in 2018. In 2021, TDFs posted 10.4% in the annual return, with the annual average return of the last five years reaching 8.0%. If cross-sectional data for each fund is used to gauge the TDF's return by target date, TDFs exhibit a typical risk-return pattern where a longer-term investment horizon leads to higher returns and greater volatility (risk). Thus, there is no big difference in risk-adjusted returns like a Sharpe ratio between TDFs. On the other hand, volatility in product-specific returns varies greatly among TDFs although they have the same investment horizon.⁵⁾ This stems from diverse TDF glide paths taken by pension providers and different compositions of the fund of funds for realizing such glide paths, which suggests that a glide path and composition of sub-funds are determinants of the TDF's risk-return pattern. However, as

5) Hong, Wonku, 2020, *Growth of TDFs and its Implications*, Issue Paper 20-30, Korea Capital Market Institute.

investors cannot access detailed information regarding TDFs' returns in advance, they have no choice but to rely on realized yields of the past when selecting a TDF product.

Implications

The discretionary default option scheme allows plan members to completely entrust independent experts with all investment decisions regarding the management of their DC plan assets. As shown in diverse cases from overseas markets, the management of retirement pension contributions through default options has been recognized as a well-designed investment product offered by pension providers, rather than a short-lived product utilized in the absence of employees' direct investment instruction. Based on such recognition, default options commonly serve as a key asset management tool during the entire pension asset accumulation phase. This explains why life cycle products like a TDF are suitable for default options. This structure requires strong investor confidence in the fund established as a default option and the pension provider designing and administering the fund. Under the circumstances, although Korea is expected to see the TDF market grow significantly with the implementation of default options, herding towards the top major funds is likely to intensify during the process.⁶⁾

Wider access to practical investment information regarding funds and pension providers is required to foster healthy competition in the TDF market. It is notable that when adopting MySuper to overhaul the existing default option scheme, Australia's superannuation underscored the standardized information disclosure to allow investors to better compare default option products.⁷⁾ Investment information provided regarding the fund of funds should contain not only realized yields delivered from previous investments but also portfolio compositions. As for TDFs, such information means details of a specific glide path and sub-funds incorporated to realize the glide path. Although such information of TDFs is generally deemed a trade secret of pension providers and not made available to the public, information of a TDF established as a default option should be an exception.

6) As of the end of 2019, the top two TDF managers (Mirae Asset Global Investments, Samsung Asset Management) account for 73.3% of the TDF market, with the top three management firms (including Korea Investment Management) taking up 84.2%.

7) A retirement pension fund is allowed to establish a single default option (MySuper) and relevant investment information should be compiled in the same format and disclosed on the supervisory authorities' official website.

In Korea, the introduction of default options is expected to help expand the TDF market. In preparation for this change, Korea's pension providers strive to launch new TDF products and accumulate a good track record. Under the circumstances, more attention should be paid to tightening the standards for disclosure of default options. A number of TDFs released in Korea's retirement pension market are products imported from overseas markets, instead of those developed by domestic pension providers. As for a TDF that is the fund of funds, there should be differences between Korea and the US in compositions of sub-funds and designing of the life-cycle glide path. Domestic pension providers should develop their own TDFs to or actively customize imported TDFs to align such products with Korea's employment conditions and household asset portfolios, quite different from those of the US.