HOW PASSIVE WORKS

The QDIA Aircraft Carrier & How Target-Date Funds Sustain It

Architecture is destiny.

Once a new product dominates a market such that the market begins to evolve around it, the product's original architecture gets locked in. Customers become accustomed to the ascendant product. Other companies build their products on top of this infrastructure. Startups in the market then face a choice: comply with the prevailing standard or fight the embedded switching costs. Seemingly better products may not win if these switching costs are too high.

This dynamic has been key to **Sequoia Capital's famous "aircraft carrier" investment strategy**. Invest in a leading product like the Apple computer. That's the aircraft carrier. Then, help it overcome the embedded switching costs by funding a related ecosystem of products, such as the disk drive and the Ethernet for the Apple PC. Those are the fleet support vessels. Together, these connected products build a new market infrastructure with switching costs that sustain each individual product on its own. Sequoia took an analogous approach with Cisco.

In the retirement market, the Qualified Default Investment Alternative is the aircraft carrier, and the Target-Date Fund is the support vessel that enables customer adoption.

How Target-Date Funds Enable the QDIA

The Target-Date Fund is the most popular QDIA implementation. As a reminder from **last week**, the QDIA is a safe harbor allowing employers to enroll employees by default into defined contribution retirement plans without legal liability for the investment returns.

Target-Date Funds are architected quite simply. Modern Portfolio Theory posits that stocks are riskier than bonds but earn higher returns over time. So TDFs put younger investors, who can weather short-term risks, more into stocks; elderly investors are weighted more heavily into bonds.

Fig 1. Vanguard allocates Target-Date Funds to passive vehicles

Asset allocation	Vanguard Target Retirement 2015	Vanguard Target Retirement 2020	Vanguard Target Retirement 2025	Vanguard Target Retirement 2030	Vanguard Target Retirement 2035
As-of date	06/30/2020	06/30/2020	06/30/2020	06/30/2020	06/30/2020
Stocks	34.89%	48.98%	59.08%	66.83%	74.47%
Bonds	63.58%	49.49%	39.37%	31.54%	23.99%
Short-term investments	1.53%	1.53%	1.55%	1.63%	1.54%
Other	—	—	—	—	—

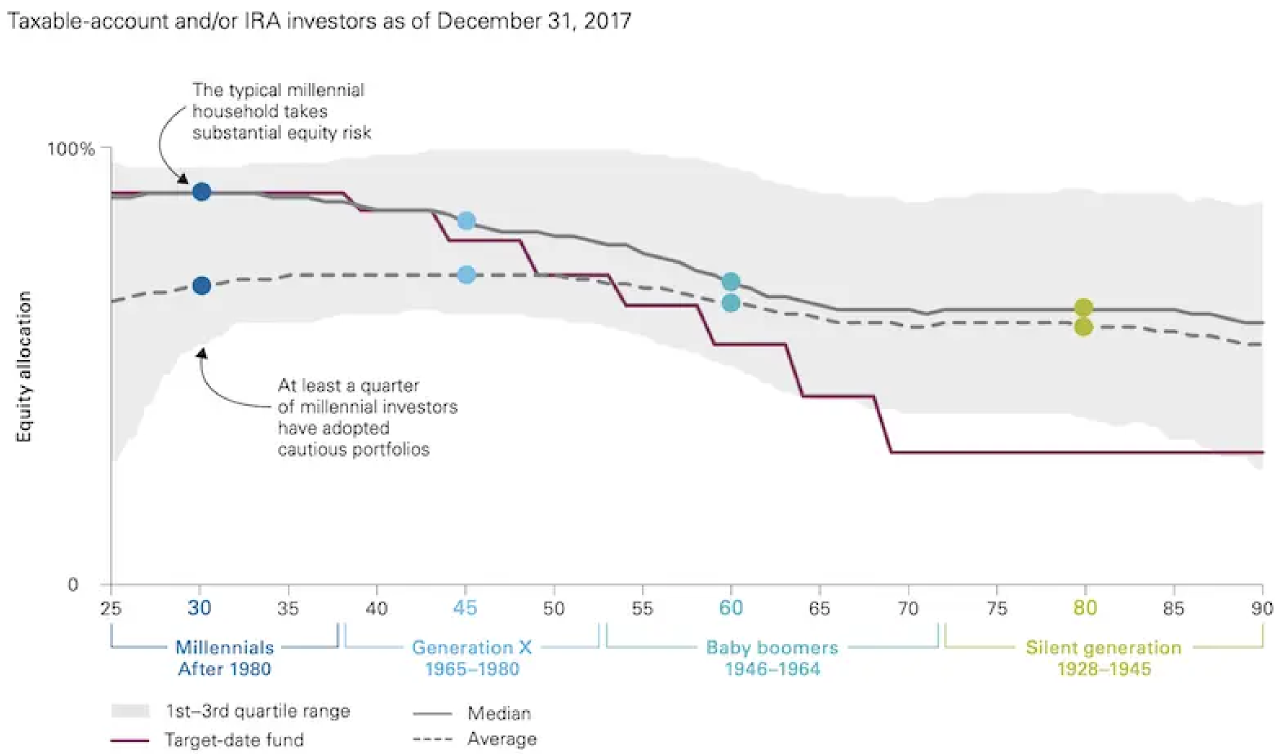
Ten largest holdings	Vanguard Target Retirement 2015	Vanguard Target Retirement 2020	Vanguard Target Retirement 2025	Vanguard Target Retirement 2030	Vanguard Target Retirement 2035
As-of date	06/30/2020	06/30/2020	06/30/2020	06/30/2020	06/30/2020
1	Vanguard Total Stock Market Index Fund Investor Shares	Vanguard Total Stock Market Index Fund Investor Shares	Vanguard Total Stock Market Index Fund Investor Shares	Vanguard Total Stock Market Index Fund Investor Shares	Vanguard Total Stock Market Index Fund Investor Shares
2	Vanguard Total International Stock Index Fund Investor Shares	Vanguard Total International Stock Index Fund Investor Shares	Vanguard Total International Stock Index Fund Investor Shares	Vanguard Total International Stock Index Fund Investor Shares	Vanguard Total International Stock Index Fund Investor Shares

Source: **Vanguard Fund Comparison**

As you can see, Vanguard invests its clients into just two passive equity funds: one for the US public market and one for the non-US public market. Not pictured are three bond funds with a similar approach. Everyone is in the same boat.

What's interesting is just how heavily adopted these products have become.

Fig 2. Age-based equity allocations among Vanguard retail investors



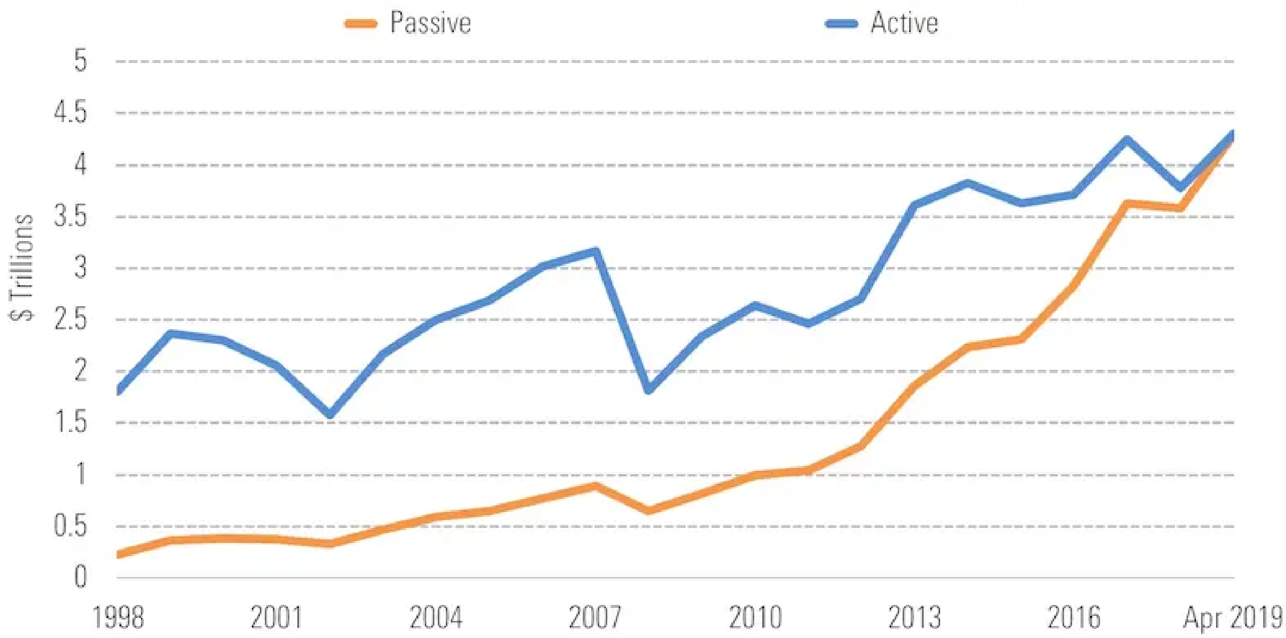
Source: **Vanguard, Risk-taking Across Generations (2018)**

The purple line shows the model Target-Date Fund allocation, and the dark gray line shows the median household's actual asset allocation. Note how the median Millennial and Gen X households closely mimic the TDF model, while the older generations do not. This shows that TDFs are much more widely adopted by younger generations, whose employers have enrolled them by default. As time goes on, these younger generations will make more retirement contributions into their TDFs and, thus, deposit more into passive equity funds. Meanwhile, the older generations will fund their golden years by selling retirement assets, which include more active equity funds.

Target-Date Funds Choose Passive Investing For You

Investors who argue, rightly or wrongly, that others should allocate more to active funds are arguing at the wrong level of abstraction. It doesn't matter if the stock market seems overvalued or undervalued. So long as people make deposits into their retirement accounts, those accounts will allocate to passive equity funds. Passive investing is now embedded into our retirement infrastructure.

Fig 3. The rise of passive over active investing



Source: **Morningstar**

Last year, US passive mutual funds surpassed active funds in assets under management. The oft-cited reasons are that passive funds offer **cheaper** and **tax-advantaged** exposure compared to active funds. An equally important reason is that they became the default retirement product.

What could change this state of affairs?

Again, the QDIA is the aircraft carrier, and it would take incredible force to change its direction. We've seen no sign of that so far. Quite the opposite, policy makers reinforced the existing system with the recently passed **SECURE Act**. They see the current approach as the most credible solution to our retirement savings shortfall.

A significant move away from passive public equity funds would therefore have to come from the Target-Date Fund allocators themselves. But do you see Vanguard suddenly pulling an about-face and favoring active investing over passive investing? It doesn't seem likely. Private equity funds, however, are a distinct possibility on the horizon.

Private Equity Enters Stage Left

Private equity funds have been lobbying for access to Target-Date Fund assets since at least 2012. Their reasoning has been that illiquid investments have tended to outperform liquid ones and that retirees should profit from these enhanced outcomes. **One early**

proposal suggested replacing defined contribution plans (read: TDFs) with defined benefit plans invested partially in private equity. The more recent push has been to keep defined contribution plans and to redirect TDF assets into private equity. Over the past few years, organizations like the **Georgetown Center for Retirement Initiatives** and the **Institute for Private Capital** have published studies supporting the investment of retirement savings into private equity. Perhaps seeing the writing on the wall, **Vanguard unveiled plans to launch a private equity fund** in February 2020.

This institutional momentum came to a head earlier this summer. In a private letter judgment, the **Department of Labor ruled** that defined contribution plan allocators may invest retirees' assets (read: TDFs) into private equity. The floodgates have been opened, and the rush is on.

The retirement capital flow infrastructure of the 2010s piped assets from defined contribution plans to Target-Date Funds to passive public equity funds. The 2020s present a more complicated picture. The system faces a stress test as the Boomer generation retires, and private equity may steal allocation away from passive public equity.

Next week, I'll give some thoughts on navigating potential macro impacts and on finding alpha opportunities at the micro level. This could be quite a sea change, so all investors should make sure that their funds are well-positioned for this capital flow environment.

Special thanks to Mike Green of Logica for his work and commentary on retirement flows and passive investing.

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How US Retirement Savings Defaulted to Passive Investing

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