NATIXIS SUSTAINABLE FUTURE FUNDS®

The evolution of target date funds

By Christopher Sharpe, CFA®

Executive Summary

Since their creation in the mid-1990s, target date series have become a staple of retirement plan investing. More recently, hybrid funds that combine the benefits of active and passive investing have begun competing for assets in a space that tends to be dominated by indexing. Portfolio Manager Christopher Sharpe reviews the evolution of target date funds and outlines five key features associated with the Natixis Sustainable Future Funds®, a target date family launched in 2017.

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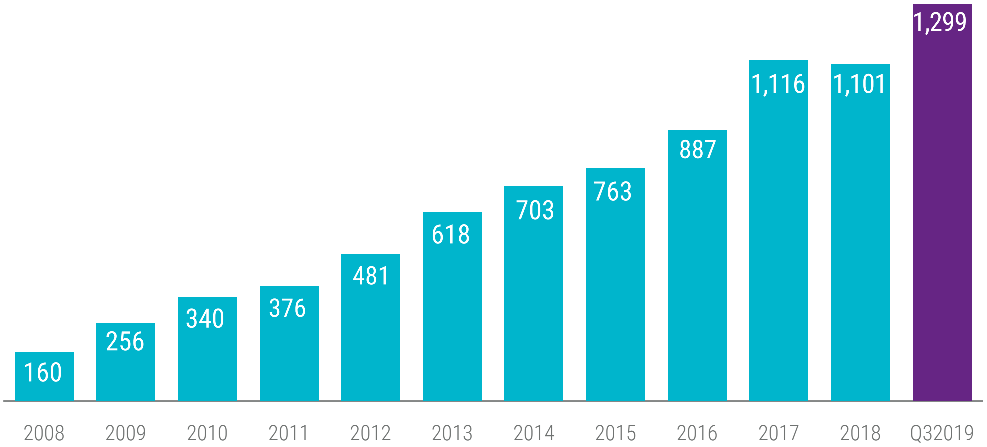
Christopher Sharpe helps oversee model portfolios for Natixis Advisors, L.P. and is the Lead Portfolio Manager for the Natixis Sustainable Future Funds® target date series. Prior to joining Natixis, Mr. Sharpe spent 15 years at Fidelity Investments, managing over $225 billion in multi-asset-class mutual funds and institutional accounts. As lead portfolio manager for the Fidelity Freedom Funds, he was responsible for portfolio strategy, design, implementation, and due diligence.

Target date funds: A foundation of retirement plan investing

Since their creation in the mid-1990s, target date mutual funds have become a staple on retirement plan menus. While growth and acceptance were slow at first, target date funds gained traction following the passage of the Pension Protection Act in 2006 (Figure 1).

FIGURE 1: Growth of assets in target date funds, $ billions



Source: ICI

Their intent has changed little in the intervening 25 years. Target date series are designed to simplify the investment process for employer-sponsored retirement plan participants by offering funds that align with a broad range of employee retirement timelines.

Target date funds are typically available in five-year increments, with year 2065 funds now available for the youngest participants. Target date funds offer plan participants the benefits of professional management, with asset allocations that evolve over time to become more conservative as the retirement target date draws closer. The trajectory of the asset allocation is determined by the funds' glide path, which may extend to the specified retirement year, or beyond it, depending on fund design.

As of 2016, target date funds accounted for 22% of all existing 401(k) assets – and 50% of all new contributions.[1] The contributions percentage is projected to reach 85% by 2022, at which point target date series would represent about half of all assets in 401(k) plans.

Key benefits for plan participants – and plan sponsors

Some of the benefits associated with an age-based target date investment approach include:

- Simplified fund selection process that can help increase participation by employees who may not be familiar with basic investment principles.
- Broadly diversified, professionally managed, risk-appropriate portfolios tailored to a participant's age or retirement time horizon.
- Consistent, long-term investment process designed to address the broad objectives of retirement savers.

Thanks to this combination of benefits, target date series are well-respected as a QDIA (qualified default investment alternative) for plan sponsors. Their age-appropriate investment strategies and broad diversification address the primary concerns associated with fiduciary responsibility.

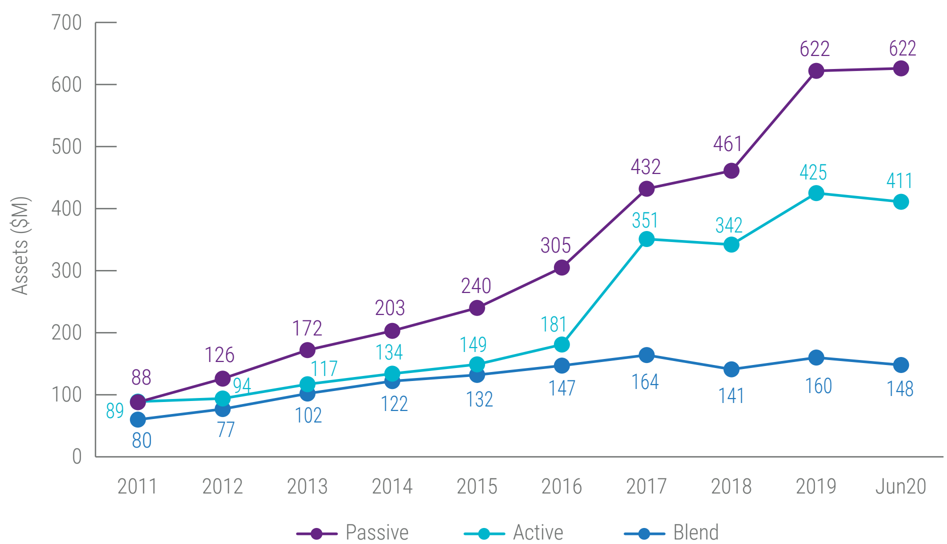
The evolution of a retirement plan staple

Unlike other investment options, target date funds are specifically designed as a single-fund solution for building retirement savings. In return for selecting the appropriate fund vintage and making regular contributions, target date investors can rely on fund managers and the asset allocation glide path to rebalance assets as needed to pursue returns and manage risk.

While target date funds have evolved over the years, they have stayed true to their original mandate: to provide retirement investors with a better path to a financially secure retirement. They differ fundamentally from funds that pursue a static investment objective and maintain an asset allocation strategy that doesn't reflect investors' changing needs over time.

The earliest target date families used actively managed mutual funds to gain asset class exposures, but that began to change in the years following the Great Financial Crisis (2007–2009). Growing acceptance of index funds during the long bull market of the 2010s – combined with heightened sensitivity to fees – resulted in faster growth for passive target date series (Figure 2). Passively managed series accounted for 47% of target date fund assets as of June 30, 2020, compared to 31% for active management and 11% for blend.

FIGURE 2: Passive target date series outpace active and blend in assets and number of funds (6/30/20)



Source: Strategic Insight Simfund

Yet even with underlying assets held in passive investments, active management is still required to ensure that the funds rebalance regularly to manage risk and adhere to their glide path. More recently, hybrid target date funds that combine the benefits of active and passive investing strategies have begun competing for assets in the target date space.

A hybrid, multi-vehicle, multi-manager target date series

The Natixis Sustainable Future Funds® were launched in 2017, using a combination of strategies designed to draw on the strengths of active and passive investment styles. While built on a target date fund chassis, they offer five key differences from more traditional offerings.

The Natixis Sustainable Future Funds' hybrid strategy is not tethered exclusively to an active revenue stream or a passive, low-fee philosophy.

#1 Hybrid active/passive approach

As technology continues to increase the efficiency of the capital markets, restricting a long-term multi-asset investment like a target date fund to an all-active or all-passive strategy shortchanges retirement savers. There are distinct benefits, risks and opportunities associated with both investment approaches.

- **Passive strategies** can be counted on to track the performance of an index – good or bad – with modest guaranteed underperformance attributable to fees.
- **Active strategies** bring the potential to outperform an index – but must overcome their higher fees in the process.

The Natixis Sustainable Future Funds employ a hybrid strategy that is not tethered exclusively to an active revenue stream or a passive, low-fee philosophy. This flexibility offers the largest opportunity set across the broad range of equity and fixed income asset classes.

The data shows that passive strategies have been most effective in specific asset classes, such as large-cap US equity, while active management tends to outperform in mid-cap value and small-cap growth. A majority of active fixed income managers also generally outperform their indexes. In some cases, even an "underperforming" active target date strategy can outpace a similarly allocated index equivalent due to its ability to invest in asset classes that are a challenge to invest in using a broad, representative passive instrument.

First half returns in 2020, including the broad equity market downturn through March 23 and the subsequent recovery through the end of the second quarter, demonstrate areas of strength and weakness for passive and active approaches (Figure 3).

The combination of mutual funds and SMAs provides flexibility to customize the portfolio so all the puzzle pieces fit together, supporting portfolio design and construction.

#2 Combination of asset and vehicle types in a single multi-asset fund

Target date funds differ from traditional mutual funds and separately managed accounts because they are designed to evolve over time to accommodate the changing needs of investors saving for and entering into retirement. Arguably, the ability to capitalize on opportunities and manage risk takes on even greater importance for target date fund investors relying on a single investment for retirement security.

FIGURE 3: Percentage of active funds that outperformed passive funds (2/20/20–6/30/20)

Morningstar Category	Downturn (2/20–3/23)	Recovery (3/24–6/30)	Peak to QE (2/20–6/30)
Large Blend	44%	47%	47%
Large Growth	79%	32%	61%
Large Value	51%	42%	54%
Mid-Cap Blend	52%	31%	39%
Mid-Cap Growth	78%	40%	60%
Mid-Cap Value	59%	71%	83%
Small Blend	28%	64%	43%
Small Growth	73%	70%	76%
Small Value	52%	36%	41%

50% or more active funds outperformed

Fewer than 50% of active funds outperformed

Data as of June 30, 2020

Unlike passive investments, there are no indexes that an active investment attempts to track or replicate. Thus, the ability of an active investment to achieve its objectives will depend on the effectiveness of the investment manager. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. Source: Natixis Portfolio Clarity®, Morningstar Direct

For this reason, constructing a target date strategy is different from creating a fund lineup for a defined contribution plan where plan participants can choose their own offerings. Building a successful multi-fund/multi-asset-class (MF/MAC) portfolio requires all of the funds and strategies to work together across the investment horizon and throughout changing market cycles. Addressing this mandate effectively requires a strategic and evolving blend of assets that serves as a complete investment portfolio in a single fund.

In addition to the underlying mutual funds, the Natixis Sustainable Future Funds use separately managed accounts (SMAs) to complement other portfolio holdings. SMAs offer the ability to customize their strategies on many levels including:

- Concentration of holdings
- Style diversification: growth/value
- Benchmark aware vs. benchmark agnostic
- ESG awareness / thematic investing
- Factor tilts: growth, dividend-paying equities, etc.

Using a combination of mutual funds and SMAs provides the flexibility to customize the portfolio across multiple asset classes so all the puzzle pieces fit together, supporting portfolio design and construction.

#3 Use of multiple managers supports strategic diversification

Strategic, qualitative diversification is essential for pursuing alpha potential and managing risk across target date portfolios. Access to multiple asset managers supports meaningful diversification that reduces the chance of investments being managed in the same way. Passively managed investments provide baseline beta exposure to key market sectors, while active asset managers bring alpha potential associated with their specific strategies.

However, it is important to recognize that active managers tend to be guided by pervasive investment philosophies and central tendencies, often based on the historical success of company founders or star managers. Across many asset management shops, individual mandates are frequently individual expressions of the same foundation. While this is desirable for a robust, repeatable investment process, multiple expressions of the same investment process do not provide effective diversification in a single-fund solution.

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For these reasons, the Natixis Sustainable Future Funds use a range of different managers to support diversification and minimize the downside of "group think." Effective diversification requires bringing together managers that operate on different axes or with different philosophies, such as pairing a fundamental manager with a quant practitioner or a bottom-up stock picker with a top-down macro manager.

For example, if the Russell 3000 represents the broad US equity market, the goal is to bring together a group of managers who zig and zag differently in the same space to build the desired allocation to US equities. The combination of their different styles, economic outlooks and philosophies can generate differentiated performance across market cycles. Think about all the different ways a square can be divided into four parts (Figure 4). The Natixis Sustainable Future Funds seek out fund managers who bring their own unique lens to security selection.

#4 Diversification due diligence – more isn't necessarily better

So how can a portfolio manager ensure meaningful and constructive diversification that creates opportunities for alpha and also manages risk? We can monitor evidence of manager diversification by analyzing specific portfolio characteristics and the path they follow over time and across changing market cycles. A partial list includes:

- Tracking error
- Active share
- Benchmark aware vs. benchmark agnostic
- Name count / portfolio concentration
- Sector / market capitalization exposure for stocks
- Duration/quality metrics for bonds

Even with this relatively small number of variables, it's easy to see there are infinite possibilities associated with combining multidimensional assets. Bringing the investments together most effectively is

FIGURE 4: Multiple managers help ensure diverse points of view

the challenge. Suppose you combine three active US equity funds and they have an aggregate tracking error close to zero. Yes, that's diversification – but you'd be better off buying the index.

Tracking error isn't necessarily the best measure, but it provides a good example. It is most valuable for evaluating a passive investment where minimal variance from the index is the goal. Otherwise, we think of tracking error as the radius of gyration around a point moving through time. We know that we don't want the tracking error to be close to zero – and then we can examine the other characteristics.

It can be helpful to think about each strategy as a sine wave moving through time around a horizontal line that represents alpha (Figure 5). The goal is to combine the strategies in a thoughtful way that smooths out the extremes, but doesn't completely offset the variances.

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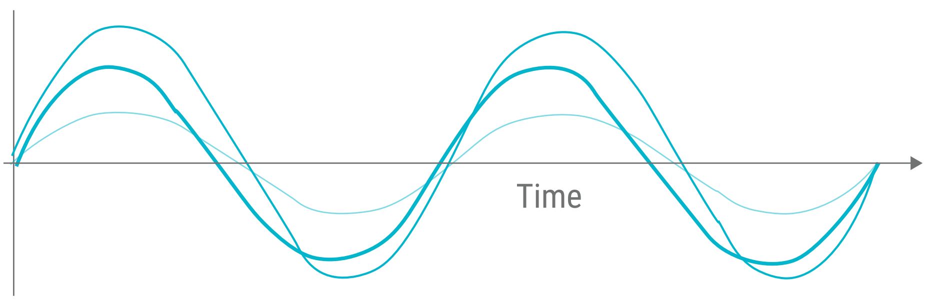
FIGURE 5: Encourage variation, but offset the extremes



- If all the strategies line up, they end up amplifying the same wave – and the resulting resonance could lead to extreme highs and lows. This runs counter to the desired result – reminiscent of the harmonic motion that triggered the historic Tacoma Narrows Bridge collapse in 1940.
- Conversely, if every movement is completely offset, it's like noise-canceling headphones. The end result is a very expensive fund that performs like the broad index.

In the Natixis Sustainable Future Funds we use a mix of diverse investment styles with low and high tracking error. We bring them together to flatten that line as much as possible, but keep it above the horizontal axis: That's our alpha.

#5 Sustainability and risk management

And finally, just as approaches to pursuing alpha can differ, so do approaches to managing risk. One key to building a successful target date series is to identify the full range of risks to the investment strategy. For this reason, awareness of ESG (environmental, social, governance) considerations is a primary component of our risk management strategy.

We consider ESG factors in the context of diversification as well as for the alpha potential ESG analysis may bring. We believe -- and there is growing evidence to demonstrate – that ESG-related risks and opportunities can be financially material for issuers. As reporting and metrics improve over time, these connections will become easier to quantify.

Unlike many traditional factors, ESG analysis can apply broadly across most asset classes, which makes it valuable information for a multi-asset portfolio. As a result, it is an integral part of the security selection and risk management processes of our underlying investment managers. In managing the funds, we intentionally select managers that incorporate ESG considerations into their decision-making processes in an effort to drive better financial outcomes for participants over the long run.

For plan sponsors, a focus on ESG considerations is consistent with research showing that retirement plan participants see strong financial reasons for investing this way. Survey data shows that 74% see a profit motive, saying they believe that companies that provide clean water and clean energy present significant growth opportunities.[2]

Similarly, given that 62% of workers overall say they are concerned about the ESG records of the companies they invest in, failing to offer these types of investments could amount to a significant oversight for plan sponsors who are concerned about participation and contribution rates.[2] Six in ten respondents simply say they would like to see more socially responsible investments in their plan offering.[2]

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THE EVOLUTION OF TARGET DATE FUNDS

Over the years, target date funds have earned the respect of plan sponsors looking to provide well-diversified, professionally managed, risk-appropriate investment options for plan participants. Looking ahead, the bigger challenge may be to find new ways to motivate employees to fund their retirement accounts more aggressively, to help them build a more sustainable financial future.

To learn more, contact us:

Visit: im.natixis.com Call: 800-862-4863

NATIXIS INVESTMENT MANAGERS

Natixis Investment Managers serves financial professionals with more insightful ways to construct portfolios. Powered by the expertise of more than 20 specialized investment managers globally, we apply Active Thinking® to deliver proactive solutions that help clients pursue better outcomes in all markets. Natixis ranks among the world's largest asset management firms[3] ($1,017.7 billion AUM[4]).

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1 Source: Cerulli Associates

2 Natixis Investment Managers, Survey of US Defined Contribution Plan Participants conducted by CoreData Research, January and February 2019. Survey included 1,000 US workers, 700 being plan participants and 300 being non-participants. Of the 1,000 respondents, 503 were Millennials (age 23–38), 249 were Gen X (age 39–54) and 248 were Baby Boomers (age 55–73).

3 Cerulli Quantitative Update: Global Markets 2020 ranked Natixis Investment Managers as the 17th largest asset manager in the world based on assets under management as of December 31, 2019.

4 Assets under management ("AUM") as of June 30, 2020. AUM, as reported, may include notional assets, assets serviced, gross assets, assets of minority-owned affiliated entities and other types of non-regulatory AUM managed or serviced by firms affiliated with Natixis Investment Managers.

Before investing, consider the fund's investment objectives, risks, charges, and expenses. Visit im.natixis.com or call 800-862-4863 for a prospectus or a summary prospectus containing this and other information. Read it carefully.

Natixis Sustainable Future Funds® important information:

The Funds are designed for investors who will be age 65 around the year indicated in each Fund's name. When choosing a Fund, investors who anticipate retiring significantly earlier or later than age 65 may want to select a Fund closer to their anticipated retirement year. Besides age, there may be other considerations relevant to fund selection, including personal circumstances, risk tolerance and specific investment goals.

Each fund's asset allocation becomes increasingly conservative as it approaches the target date and beyond. Allocations may deviate plus or minus 10% from their targeted percentages.

Investments in the Funds are subject to the risks of the underlying funds and separately managed segments. Principal invested is not guaranteed against losses. It is possible to lose money by investing in the Funds, including at and after the Funds' target date.

Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. Use of overlay management and tax management strategies does not guarantee a profit or protect against a loss in an investor's portfolio.

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