The Untapped Potential of Target Date Funds in Japanese Retirement Accounts

As more individuals in Japan transition from simply saving to actively investing for the long term, they are increasingly faced with important questions about not only what products to invest in, but also how to adjust their investment strategy as their life circumstances and financial goals evolve. Market conditions shift, personal circumstances change, and the optimal investment strategy at age 30 could be far less appropriate at age 60.

This underscores the importance of diversified portfolios that can balance growth and income goals across different life stages. Target date funds (TDFs) offer an effective solution. By automatically adjusting their asset allocation as the investor approaches and enters retirement, TDFs are designed to meet changes to risk profiles and investment horizons over time in a single, professionally managed vehicle. Their built-in diversification and lifecycle design make them particularly well-suited for use in defined contribution (DC) pension systems and for investors seeking simplicity without sacrificing long-term planning discipline.

Widely used in the U.S. retirement system, TDFs are designed to help individuals navigate complex investment choices with ease and confidence.

As policymakers in Japan pursue DC pension reforms, ICI is pleased to share insights on how TDFs can enhance retirement readiness and serve as an effective default option in Japan's evolving investment landscape. In this article, we examine the success of TDFs in the U.S. retirement system and explore the benefits of using these diversified investment vehicles as the default in Japanese retirement accounts.

What Are Target Date Funds?

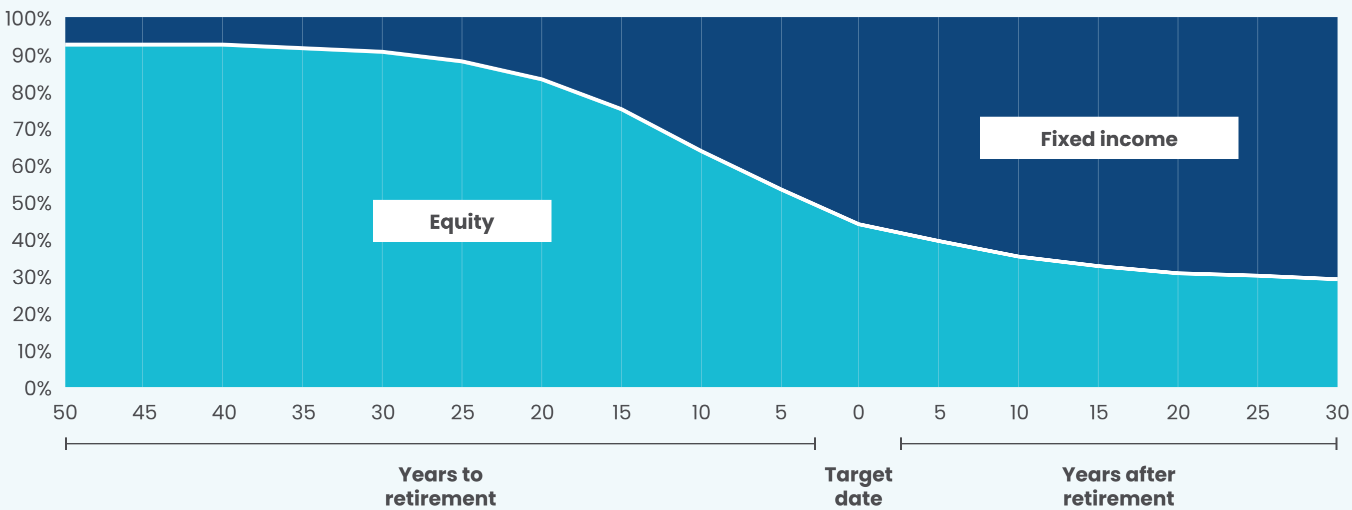
A TDF is a type of balanced investment fund that holds a mix of equities and bonds and rebalances over time. Investors typically select a TDF with the target year that aligns closely with their expected retirement date. The fund is structured to gradually shift its asset allocation over time from a higher concentration in equities during the early years of working (when investment growth is prioritized) to a greater emphasis on fixed income investments as the target date nears and passes. This systematic rebalancing allows TDF to balance long-term growth potential with increasing focus on income as the investor nears retirement.

This gradual reallocation is called a "glide path." Each investment management firm that offers TDFs has its own specific glide path formula, indicating the changing shares of equities and bonds over time. On average, most TDFs in the United States begin with about a 90% allocation to diversified equities, falling to about 44% by the target date, and most continue to gradually adjust the allocations past the target date.

Using TDFs in retirement accounts offers many benefits for investors:

- TDFs are well-suited for individuals with limited investment experience or for those who prefer a "hands-off" approach, as these funds automatically adjust over time and eliminate the need for investors to actively monitor and rebalance their portfolios.
- TDFs offer a resilient, diversified strategy designed to grow retirement savings while adapting to changing financial needs. In contrast, relying on cash savings and principal-guaranteed products, which remain common in Japan, can lead to a gradual erosion of purchasing power in a higher inflation environment.
- TDFs are a cost-effective approach to access a diversified and professionally managed portfolio.

TDFs Use a Glide Path to Automatically Rebalance Over Time



Source: Investment Company Institute tabulations of Morningstar data

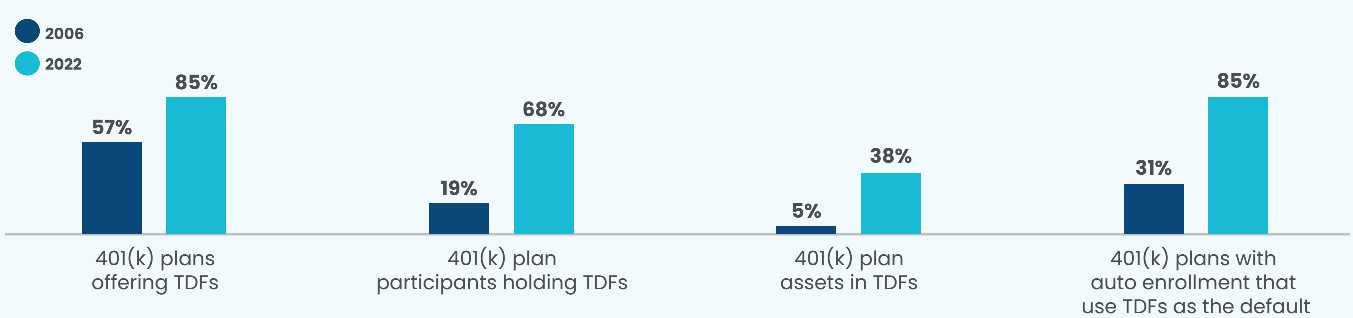
The Growing Popularity of Target Date Funds in the United States

The first TDF was introduced in 1994 to address the needs of busy workers who had 401(k) retirement plans through their employers and wanted professional management of their asset allocation. Since then, these funds have revolutionized the U.S. retirement landscape.

In 2007, a pivotal regulatory change recognized that individuals saving for retirement shouldn't put all of their eggs in one basket. The U.S. Department of Labor designated TDFs as one of the qualified default investment alternatives (QDIAs) for 401(k) plans. This change enabled employees to be automatically enrolled in professionally managed, age -appropriate TDFs, ensuring that even passive participants in DC plans benefit from a diversified portfolio that systemically rebalances assets over time as they approach retirement.

Because of their ease of use and effectiveness, TDFs have quickly become a retirement investing staple for millions of Americans, with 401(k) plan sponsors and participants increasingly embracing TDF investing. At year-end 2022, 85% of 401(k) plans included TDFs in their investment lineup, and by 2023, 86% of 401(k) plans using automatic enrollment had designated TDFs as the default investment option for new participants. Due to these changes and the growing popularity of TDFs, at year-end 2022 nearly 40% of 401(k) plan assets were invested in TDFs and TDFs were used by nearly 70% of 401(k) participants.

TDF Use in 401(k) Plans Has Substantially Increased Over Time

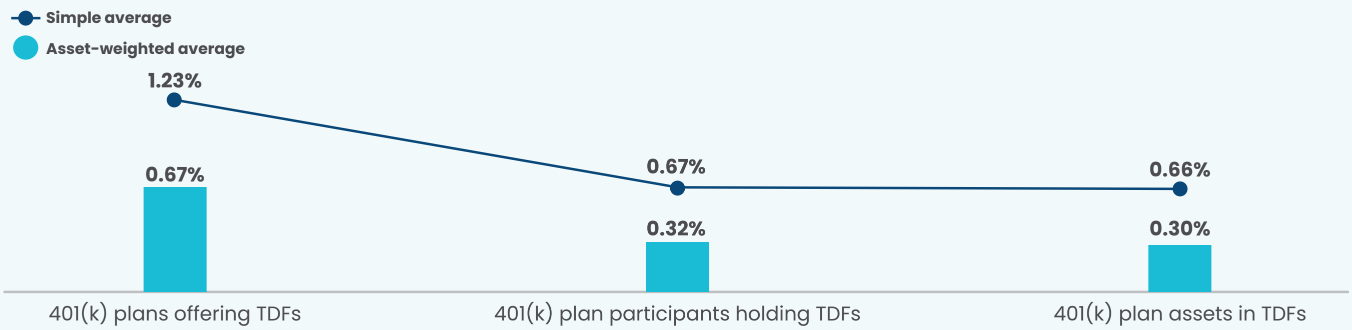


Sources: EBRI/ICI 401(k) Database; and Plan Sponsor Council of America, Annual Survey of Profit Sharing and 401(k) Plans

Finally, TDFs are a cost-effective approach to access a diversified and professionally managed portfolio. In the United States, competition and economies of scale have pushed TDF expense ratios down substantially. For example, mutual fund TDF expense ratios in the United States have fallen by more than half since 2008 and averaged only 0.30% as of 2023.

While participants in employer-sponsored U.S. defired contribution retirement plans can choose to invest in products other than TDFs, these funds continue to gain popularity, particularly among younger 401(k) plan participants, because of their ease of use and ability to help individuals stay on track to achieve their long-term investing goals.

TDF Mutual Fund Expense Ratios Have Fallen Substantially



Source: Investment Company Institute tabulations of Morningstar data

The Promise of Target Date Funds in Japan

Although TDFs have been allowed as the default fund within Japanese DC plans since 2018, they are still not widely utilized. Currently, **only 7.7% of corporate DC plans use TDFs as the default designated fund**, while the majority instead continue to use cash and capital preservation as defaults.[1]

The impact of the current approach is clear: Japanese retirement accounts remain, on average, heavily weighted in cash, leaving household savings increasingly exposed to inflation and at risk of losing purchasing power in today's shifting economic environment.

Indeed, the Financial Services Agency of Japan highlighted this concern in its 2023 Asset Management Progress Report noting that even participants in their 20s enrolled in corporate DC plans held 38.5% of their assets in principal-preservation products such as savings and insurance.[2]

ICI has **provided recommendations to the Japanese government** advocating for the greater use of diversified investment vehicles like TDFs as the default investment for corporate DC plans and individual-type DC pension plans (iDeCo).

Making greater use of TDFs as the default investment option, especially for individuals early in their careers, can help direct retirement savings into growth-oriented assets at a time when investors have a greater capacity to take on market variability. Over time, investment in TDFs can lead to stronger asset accumulation and better meet individuals' long-term retirement needs.

The popularity of TDFs in the United States provides a glimpse into the possibilities available to Japanese households as well as the asset management industry. The moment is ripe for Japan to advance reforms that foster a shift from saving to investing for retirement and facilitate the broad use of diversified investment vehicles such as TDFs to help households build a secure financial future.

[1] Results of the 2023 Survey on the Actual State of Corporate Defined Contribution Pension Plans (Japanese language) **https://www.pfa.or.jp/activity/tokei/files/dc_chosa_kessan2023_1.pdf**

[2] Asset Management Industry Advancement Progress Report 2023 - Toward Improving Trust and Transparency – (Japanese language) **https://www.fsa.go.jp/news/r4/sonota/20230421/20230421_1.pdf**

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The Investment Company Institute (ICI) is the leading association representing the global asset management industry in service of individual investors. ICI members are located in North America, Europe, and Asia and manage fund assets of US$50 trillion, including mutual funds, exchange-traded funds (ETFs), UCITS, closed-end funds, unit investment trusts (UITs) and similar funds in these different jurisdictions. ICI has offices in Washington DC, Brussels, and London.