



# How We Design a Blend Solution for Target Date Investors

Mixing active and passive investments in a target date solution.

November 2023

## KEY INSIGHTS

- We are committed to delivering successful retirement outcomes through a range of target date solutions for our clients to help meet their needs and objectives.
- Our blend target date approach is designed with a goal of delivering a lower fee profile and reduced tracking error with the benefits of our approach to active management.
- We believe the pursuit of lower costs must be balanced with the need for broad diversification and the potential for excess returns.

Given our leadership in the target date marketplace, we have a strong commitment to research and innovation to help meet investors' evolving needs. Our target date suite is built on the principle that investor preferences should drive design. For that reason, we manage an array of solutions to meet the range of needs we know exist in the market.

A number of plan sponsors have sought out target date strategies that offer lower fees and reduced tracking error.<sup>1</sup> Importantly, they are seeking solutions from providers that can restrain costs but offer a full opportunity set of asset classes that can potentially generate excess returns and greater portfolio growth.

In addition to delivering a strategy that combines the value of active management with the lower costs

of passive management, we believe our blend target date approach offers investors:

- A thoughtful glide path design tailored to help support investors' objectives, which seeks to balance risk and return potential in line with our research on participant preferences and behavior.
- Enhanced diversification in asset categories that can only be adequately achieved through active management.
- A suite of strong underlying building blocks.
- A robust tactical allocation decision-making process that rigorously assesses market risks and opportunities.
- An experienced team that has managed target date strategies through multiple market cycles.



**Wyatt Lee**

*Head of Target Date Strategies*



**Kim DeDominicis**

*Portfolio Manager, Target Date Strategies*



**Andrew Jacobs van Merlen**

*Portfolio Manager, Target Date Strategies*

<sup>1</sup> Tracking error is a measure of how closely portfolios track their benchmarks.

“...we explored the trade-offs between our active and passive strategies in terms of their potential impact on a range of outcomes, such as cost, excess return potential, and diversification, among other factors.

### **Solving for Client Needs**

Plan sponsors often have unique needs and specific objectives in their selection of target date offerings. Lower cost solutions that couple the benefits of active and passive management are among them. We recognize that some passive investments can provide efficient capital market exposure in select sectors while also delivering significant cost reduction. Importantly, however, we believe our actively managed portfolios can generate excess returns and diversification through exposure to market segments in which passive management cannot drive desired outcomes.

The primary goal of our blended approach is consistent with that of our existing suite of target date solutions: to balance providing support for lifetime income with reducing volatility near retirement through a risk-aware design. We firmly believe that a fully active approach presents the greatest opportunity to generate excess returns, but we also recognize that, for some, this goal must be balanced alongside other considerations. To that end, we sought to design a solution to meet plan sponsors' needs without sacrificing participants' outcomes.

### **Building a Blend Solution**

We sought to design a target date approach that blends T. Rowe Price's passive and actively managed investments that aim to deliver a lower fee profile and reduced tracking error while maintaining many of the benefits of active management. Through an iterative evaluation process, we explored the trade-offs between our active and passive strategies in terms of their potential impact on a range of outcomes, such as cost, excess return potential, and diversification, among other factors.

Fixed income and equity portfolios have divergent characteristics and are impacted by different factors, particularly when considering the implementations of a blended approach between active and passive investments. For that reason, we considered our approach to the broad asset classes separately.

### **Fixed Income—Improved Diversification**

We believe in broad diversification<sup>2</sup> within fixed income and, therefore, have implemented allocations across both core and diversifying fixed income sectors. As part of our design process,

### **Complexities—Index Replication and Tracking Error**

The goal of a manager of a passive strategy is to replicate the performance of a benchmark or index the strategy is intended to track. The ease of replicating an index varies meaningfully across asset classes. Tracking error is a useful measure of how closely portfolios track their benchmark. In certain market segments, like U.S. large-cap equities, tracking error of passive investments tends to be lower, as it is relatively easier for passive managers to purchase the securities that compose the index in the proportions needed to replicate index returns. However, in other areas, particularly in fixed income, tracking error tends to be a more notable challenge.

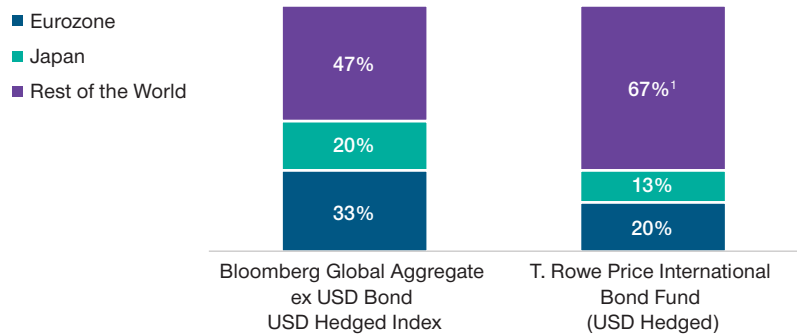
The Credit Suisse High Yield Index, for example, consists of over 1,200 distinct securities from multiple sectors.<sup>3</sup> Many of these bonds are issued in relatively limited quantities and may trade infrequently, or not at all, in the secondary market. Further, new issuance, maturities, credit rating changes, and redemptions can continuously alter the makeup of a bond index, thereby increasing the difficulty of fully replicating the index and potential for tracking error.

<sup>2</sup> Diversification cannot assure a profit or protect against loss in a declining market.

<sup>3</sup> As of September 30, 2023.

## Our Active Approach Offers Favorable Diversification

(Fig. 1) Regional diversification comparison



For illustrative purposes only.

As of September 30, 2023.

Source: T. Rowe Price. Source for Bloomberg Index data: Bloomberg Finance L.P.

<sup>1</sup> Reserves are included in this figure, which represented 10.33% of total net assets of the fund as of September 30, 2023. Figures are rounded.

“Beyond the potential for inefficiency and high tracking error, we found that accurate index exposure in certain sectors may produce unfavorable outcomes.

we evaluated the trade-offs of active and passive investments across each fixed income sector in which we invest. For each sector, we evaluated a passive investment’s ability to achieve efficient exposure with low tracking error as well as the attractiveness of gaining that exposure passively.

While passive investment strategies within certain fixed income market segments face significant challenges gaining efficient exposure, our research indicates that passive can be appropriate in other market segments due to the relative ease of benchmark replication and reasonably well-contained tracking error within those sectors. For example, based on our analysis, we believe passive investments within the U.S. investment-grade and U.S. Treasury segments can be employed. Additionally, we believe passive exposure to these sectors is more prudent given their high credit quality. This allocation to passive fixed income investments could also enable us to maintain an allocation to active equity while maintaining a similar mix of active and passive exposures across our portfolios.

In more specialized fixed income sectors, our analysis suggests that an active management approach can be

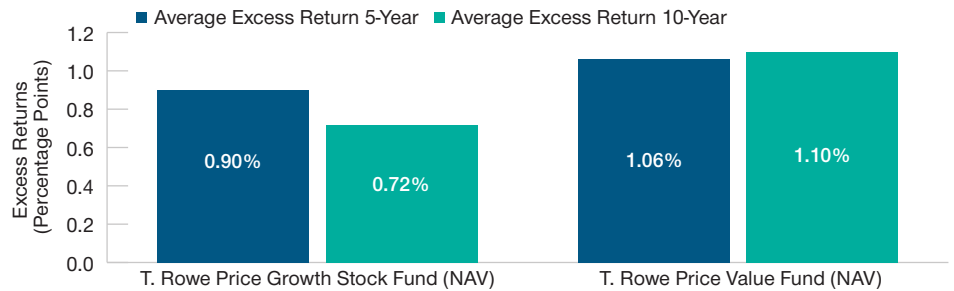
preferable, as index returns can be more challenging to replicate through passive portfolios. In these sectors—such as high yield and emerging markets debt—passive managers may not be able to purchase and hold some benchmark securities at appropriate weights, and there can be heightened liquidity risks. As a result, tracking error for a passive strategy in these sectors comparably can be as high as an active strategy, and performance may fail to appropriately track the stated benchmark.

Beyond the potential for inefficiency and high tracking error, we found that accurate index exposure in certain sectors may produce unfavorable outcomes. In some cases, the securities that dominate particular indexes may have potentially unattractive qualities:

- Within high yield debt, index representation skews toward the most highly leveraged issuers. This can expose investors to greater default risk and can also create sector concentrations.
- In emerging markets debt, benchmark representation is typically limited to sovereign issues, which reduces the opportunity set available to investors.

## Active Management Maximizes the Potential for Excess Returns

(Fig. 2) Average annualized excess returns (net of fees)



For illustrative purposes only. Please see Standardized Performance table at the end for additional important information.

**Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or loss when you sell your shares.**

**Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions. To obtain the most recent month-end performance, please visit our website or contact a T. Rowe Price representative at 1-800-225-5132.**

The benchmark used for the Growth Stock Fund excess returns calculation is the Russell 1000 Growth Index, which was used because of its similar style focus. The benchmark for the Value Fund is the Russell 1000 Value Index. The excess returns show how the fund has performed compared to its benchmark. As of September 30, 2023. Data is calculated on a monthly basis over a 20-year period and is based on returns over rolling 5- and 10-year periods.

Source: T. Rowe Price, Russell (see Additional Disclosure).

- In international developed debt markets, indexes tend to skew toward a high concentration of issuers in a limited number of countries, which increases idiosyncratic risk.

We believe target date strategies should have strategic exposure to these sectors, which provide important, long-term diversification benefits. In our view, exposure to these sectors can be best achieved through an active management approach.

### Equities—Potential for Excess Returns

Among equities, we found that the appropriateness of passive and active vehicles similarly varied across market segments and styles. In core allocations to U.S. and international developed markets equities, we determined that passive allocations could achieve efficient market exposure while restraining cost.

However, we found that—given the magnitude of potential excess returns—desirable outcomes were most supported by combining these passive allocations with our active allocations to narrower, style-based segments. We believe our active capabilities in growth- and value-focused segments in the U.S. and international developed markets provide opportunities to maximize potential excess cost-adjusted returns that may deliver value for plan participants.

For instance, passive investments in U.S. equities present opportunities to gain efficient market exposure at lower cost and minimal tracking error. We believe that a purely passive approach to the segment may limit the ability to generate excess returns. In particular, we have maintained a sizable allocation to U.S. large-cap equities throughout the glide path, and we believe the magnitude of potential value added from our active strategies within U.S. large-cap equities outweighs the lower cost of a

“Our emphasis is on participant outcomes, and we have a high conviction on maintaining active allocations where we believe we can add significant value.

passive alternative.<sup>4</sup> Given our sizable equity allocation and our track record of generating excess returns net of fees within U.S. large-cap equities, we believe it is prudent to utilize a degree of active management within the space.<sup>5</sup> Our emphasis is on participant outcomes, and we have a high conviction on maintaining active allocations where we believe we can add significant value.

While efficient passive market exposure is available in certain market segments, we feel that investment opportunities in a number of sectors could also be enhanced through our active management approach. We believe that passive options in emerging markets equities are less desirable, as they are generally viewed as largely inefficient markets and because some indexes may

skew heavily toward concentration in a few countries. Our suite of target date solutions also maintains an allocation to real assets equities, which can enhance diversification and provide a potential hedge against inflation. In our view, the universe of passive investments does not offer an adequate alternative for this allocation.

### Conclusion

By including a blend approach in our suite of target date solutions, we believe we can provide plan sponsors a unique alternative that stands out from the existing universe of investment options. The integration of active and passive strategies in our blended approach may offer investors the potential for lower costs and the opportunity to benefit from excess returns driven by fundamental research.

## Standardized Performance

Periods Ended September 30, 2023

	Annualized			
	1 Year	3 Years	5 Years	10 Years
Growth Stock Fund (Net of Fees)	26.79%	1.44%	7.47%	11.70%
S&P 500 Index <sup>1,2</sup>	21.62	10.15	9.92	11.91
Russell 1000 Growth Index <sup>1</sup>	27.72	7.97	12.42	14.48
Value Fund (Net of Fees)	13.48	11.78	8.01	9.23
Russell 1000 Value Index <sup>1</sup>	14.44	11.05	6.23	8.45

**Performance data quoted represents past performance and is not a reliable indicator of future performance. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance, visit [troweprice.com](http://troweprice.com).**

The Growth Stock Fund's expense ratio as of the most recent prospectus was 0.67%. See the prospectus for details. The Value Fund's expense ratio as of the most recent prospectus was 0.72%. See the prospectus for details.

Sources: Standard and Poor's and Russell (see Additional Disclosures).

Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions.

<sup>1</sup> Index return figures shown with gross dividends reinvested.

<sup>2</sup> The benchmark as shown in the most recent prospectus is the S&P 500 Index.

Performance provided is for illustrative and informational purposes only. It is intended to illustrate the research and decisions behind the creation of the Retirement Blend Funds, which inceptioned on July 26, 2021. The performance provided does not represent the performance of the Retirement Blend Funds, and the Retirement Blend Funds do not have a performance history prior to July 26, 2021.

<sup>4</sup> The allocation is largest furthest from retirement age and decreases over time.

<sup>5</sup> Based on rolling 5- and 10-year annualized total returns for our Growth Stock Fund and Value Fund compared with their benchmarks.

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**Target Date Investing Risks**—The principal value of the target date strategies are not guaranteed at any time, including at or after the target date, which is the approximate year an investor plans to retire (assumed to be age 65) and likely stop making new investments in the funds. If an investor plans to retire significantly earlier or later than age 65, the funds may not be an appropriate investment even if the investor is retiring on or near the target date. The funds' allocations among a broad range of underlying T. Rowe Price stock and bond funds will change over time. The funds emphasize potential capital appreciation during the early phases of retirement asset accumulation, balance the need for appreciation with the need for income as retirement approaches, and focus on supporting an income stream over a long-term post-retirement withdrawal horizon. The funds are not designed for a lump-sum redemption at the target date and do not guarantee a particular level of income. The funds maintain a substantial allocation to equities both prior to and after the target date, which can result in greater volatility over shorter time horizons.

**Diversification cannot assure a profit or protect against loss in a declining market.**

**Active investing** may have higher costs than passive investing and may underperform the broad market or comparable passive funds with similar objectives. **Passive investing** may lag the performance of actively managed peers as holdings are not reallocated based on changes in market conditions or outlooks on specific securities.

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**Additional Disclosure**

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**Past performance is not a reliable indicator of future performance. Additional Risks:** All investments are subject to market risk, including the possible loss of principal. The value approach to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced. Growth stocks are subject to the volatility inherent in common stock investing, and their share price may fluctuate more than that of a income-oriented stocks. Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in high-yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets. All charts and tables are shown for illustrative purposes only.

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