

# Five key factors to help improve retirement outcomes for target date strategy investors

The variability of capital markets can lead to a range of outcomes, but the odds of achieving a desired retirement goal can be improved through skilled investment management and prudent savings behavior.

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## Key Takeaways

- Achieving a desired level of annual retirement income using a target date strategy is a three-way effort involving a retirement plan sponsor, a plan participant, and an investment manager.
- Differences among investment returns and savings behaviors can lead to a range of outcomes for retirement savers investing in a target date strategy.
- Identifying a target date strategy manager with broad research and investment capabilities and understanding the manager's philosophy, principles, and approach are central to pursuing successful retirement outcomes.
- Higher savings rates, starting to save earlier in life, and consistently saving until a target retirement date can help to increase a participant's retirement income.

Target date strategies have become the default investment option in a majority of workplace retirement savings plans today, and are a primary retirement savings vehicle for a large percentage of American workers. At the end of 2016, more than 87% of defined-contribution workplace savings plans used a target date strategy as the default investment option, up from 62% in 2008.<sup>1</sup> At the same time, more plan participants are using target date strategies exclusively to save for retirement. As many as 45% of participants had 100% of their assets invested in a target date strategy at the end of 2016, up from 15% in 2008.<sup>2</sup>

Target date strategies are designed to be an appropriate retirement savings option for a range of investors, as many have different savings behaviors and because capital markets performance can vary over time. The goal of many target date strategy investors is to support income needed throughout retirement, while maintaining a similar standard of living. This goal can be achieved by accumulating sufficient assets to replace an appropriate portion of one's pre-retirement salary during the retirement years. An **income replacement rate** refers to the percentage of an investor's final pre-retirement salary that he or she could withdraw annually during the retirement years. For example, an income replacement rate of 45% for an employee earning \$100,000 prior to

retirement, would mean that the investor could withdraw \$45,000 annually throughout retirement.<sup>3</sup>

Achieving a desired level of retirement income using a target date strategy<sup>4</sup> is a three-way effort involving the retirement plan sponsor, a plan participant (eligible employees), and an investment manager (see Exhibit 1). Plan sponsors face the task of designing a workplace retirement savings plan. Participants are responsible for making contributions to their savings plans. A target date strategy investment manager is responsible for the strategy's investment performance.

Our research examined the impact of investment returns and various participant savings behaviors on potential retirement outcomes for investors using hypothetical scenarios intending to serve as proxies for target date investments. We considered three types of target date

#### EXHIBIT 1: Plan sponsors, plan participants, and investment managers all play a role in helping participants achieve a desired target level of annual retirement income.

Key Contributors to an Employee's Retirement Readiness

##### Plan Sponsors

Adopting certain plan design features, such as auto-enrollment, an annual increase program, and a company match program, can enhance an employee's ability to achieve a better retirement outcome.

##### Plan Participants

Employees who are active participants in their plan and maximize their contributions can improve the likelihood of reaching their long-term goals.



##### Investment Managers

Investment managers should be committed to improving retirement outcomes for participants and plan sponsors by providing access to best-in-class investment resources, expertise, and strategies.

Source: Fidelity Investments.

strategy participant profiles, each with a total annual contribution rate that reflects any combination of participant and employer matching funds:

- **3% Saver:** saves 3% of his or her salary annually throughout a career. Many participants are defaulted into a target date strategy at this savings rate.<sup>5</sup>
- **7% Saver:** saves 7% of his or her salary annually throughout a career. Our recordkeeping insights show that the average deferral rate for participants who proactively enroll in a target date strategy is 7%. For simplicity of our analysis, we also assumed that the 7% savings rate remained constant throughout the saver's life cycle.<sup>6</sup>
- **6%–18% Saver:** begins saving at 6% through auto-enrollment, and has an auto-increase feature that increases the contribution by 1% each year until the employee is contributing 18% of his or her annual salary. At that point, contributions are stable at 18% each year. Over a lifetime, the average contribution for this participant is approximately 15%.<sup>7</sup>

We simulated 100,000 different performance paths that a target date strategy could take over an investor's lifetime (ages 25 through 93). Using Fidelity's strategic glide path as a proxy for a target date strategy's glide path (i.e., time-varying strategic asset allocation), we simulated the returns for U.S. equities, non-U.S. equities, U.S. investment-grade bonds, and short-term debt to evaluate the potential range of outcomes for our three saver profiles.<sup>8</sup> Our analysis revealed five factors that can influence retirement outcomes for participants invested in a target date strategy.

### Five Factors Target Date Strategy Investors Should Consider

#### 1. The importance of investment returns

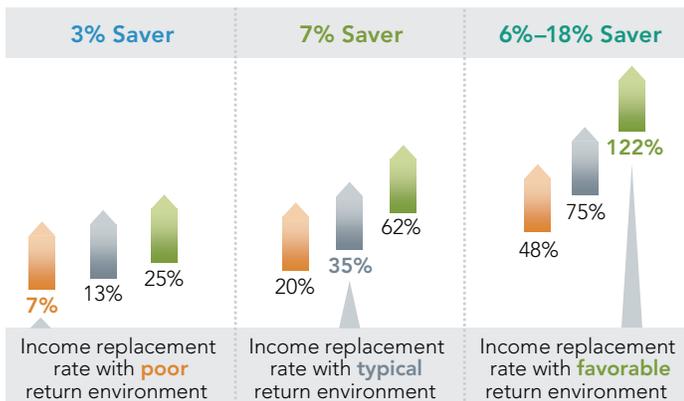
While retirement savers can adopt good savings behavior, investment returns—via capital markets performance

and manager effectiveness—can influence a participant’s retirement outcome in a meaningful way.

Historical returns are a component of any investment strategy, but the future may not look like the past. Asset class returns can deviate from long-term averages due to macroeconomic factors such as interest rates and inflation, as well as geopolitical factors. Such factors can influence long-term target date strategy performance, and may affect target date strategies differently. For example, unusually low equity or bond returns during an extended period could result in a lower level of retirement income, provided

**EXHIBIT 2: Both investment returns and savings behaviors can influence a target date strategy investor’s annual retirement income.**

The Importance of Investment Returns and Savings Behaviors



“Return environment” is defined as “Favorable,” “Typical,” or “Poor” within the range of simulated annualized returns that a hypothetical investor may experience. 100,000 different annualized return scenarios were generated using stochastic, or randomly generated, simulations. The participant assumptions used in the simulated analysis include: Start age–25; Retirement age–65; Retirement planning age–93; Asset allocation strategy: Fidelity’s Target Date Strategy glide path. “Favorable” represents the top third of simulated return scenarios, “Typical” represents the middle third of simulated return scenarios, and “Poor” represents the bottom third of simulated return scenarios. Each bar represents the minimum level of attainable real income replacement given an investor’s hypothetical return experience, with 90% confidence. For example, in 90% of the simulated scenarios, the “6%–18% Saver” investing through a “Typical” return environment would realize an income replacement rate of 75% or greater, of their final pre-retirement salary. The asset classes include U.S. equities, non-U.S. equities, U.S. investment-grade bonds, and short-term debt. The results do not include the impact of taxes and fees. IMPORTANT: The projections regarding the likelihood of various outcomes are hypothetical in nature, do not reflect actual investment results, and are in no way guarantees of future results. Please see appendix for additional information regarding stochastic simulations and indexes used. Source: Fidelity Investments.

those returns resulted in lower-than-average asset investment performance throughout the participant’s life cycle.

To measure the influence of investment performance on our three retirement saver profiles, we evaluated the potential outcomes in three different hypothetical return environments over the approximately 70-year planning horizon. We divided 100,000 different return simulations into three distinct categories based on their average annual inflation-adjusted (i.e., real) return and labeled as follows:

**“Poor” return environment:** 3% real return (the median return of the bottom third of all simulated returns).

**“Typical” return environment:** 5% real return (the median return of the middle third of all simulated returns).

**“Favorable” return environment:** 7% real return (the median return of the top third of all simulated returns).

Our analysis showed the combined impact of investment performance and savings rates on outcomes for our three target date strategy saver profiles (Exhibit 2). We would like to highlight two key observations:

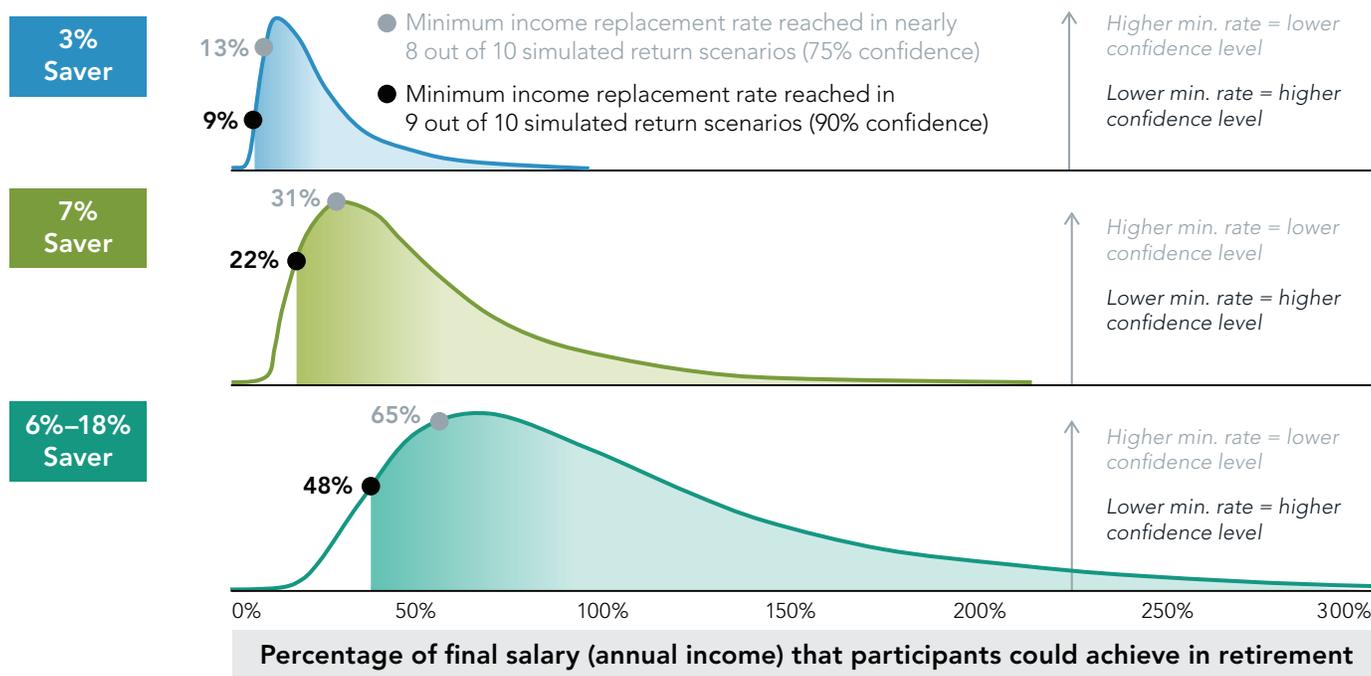
- **First, the return environment has a meaningful influence on all savers’ annual retirement income.** For example, the 6%–18% Saver would realize an annual income replacement rate of 75% or more in a typical return environment over his or her retirement period, at a 90% confidence level (meaning the simulations supported income replacement levels at least this high in 9 out of 10 return scenarios). The same saver would achieve a higher minimum level of retirement income in a favorable return environment (122% or more), and a lower minimum level of retirement income in a poor return environment (48% or more).
- **Second, better return environments have a more positive impact for participants with higher savings rates than participants with lower savings rates.** As

the return environment moved from poor to favorable, the minimum income replacement rate for a 3% Saver ranged from 7% to 25%, or approximately 18 percentage points. By comparison, the range of outcomes for the more aggressive 6%–18% Saver is 74 percentage points, ranging from the poor to the favorable return environment (Exhibit 2). As such, the spread in potential minimum income replacement outcomes between the poor and the favorable return environments widens as the participant’s savings rate increases. This range of outcomes among saver profiles captures the

interaction between savings rates and investment returns. It’s also important to keep in mind that an investment manager’s skill—in terms of asset allocation and risk management, among other factors—also plays an important role in a target date strategy investor’s return over a life cycle. A manager’s asset allocation decisions are typically influenced by forward-looking views of the capital markets; these view can vary, and result in different returns for investors in various target date strategies.<sup>9</sup>

**EXHIBIT 3: Although a range of outcomes can be expected for any target date strategy investor (shaded area), plan participants who saved consistently at a higher rate were more likely to experience higher income and a wider range of potential outcomes.**

Higher Savings Rates Can Lead to Higher Retirement Income



The distribution curve is illustrative of the range of attainable income replacement rates (x-axis) and the frequency of attaining a given income replacement rate (y-axis) for a hypothetical investor. The distribution is illustrative of approximately 100,000 randomly generated scenarios. The distribution is derived using stochastic, or randomly generated, simulations and is based on the following assumptions: Starting age, 25; Retirement age, 65; Retirement planning age, 93. The lifetime strategic asset allocation for the analysis is based on Fidelity’s strategic glide path. The asset classes include U.S. equities, non-U.S. equities, U.S. investment-grade bonds, and short-term debt. The stated income replacement rate represents the minimum real income replacement rate of a hypothetical investor’s experience, with 90% confidence, based on a final pre-retirement salary. For example, in 90% of the simulated scenarios, the “6%–18% saver” would realize a real income replacement rate of 48% or greater. The assumptions for three savings scenarios are: “3% Saver:” 3% constant savings from age 25 through 64 (no employer match, no increase); “7% Saver:” 7% constant savings from age 25 through 64 (no employer match, no increase); “6%–18% Saver:” 6% savings rate beginning at age 25, increasing 1% each year until 18%, 18% thereafter through age 64 (no employer match). The results do not include the impact of taxes and fees. All Saver scenarios reflect an annual inflation-adjusted salary growth rate of 1.5%. IMPORTANT: The projections regarding the likelihood of various outcomes are hypothetical in nature, do not reflect actual investment results, and are in no way guarantees of future results. Please see appendix for additional information regarding stochastic simulations and indexes used. Source: Fidelity Investments.

## 2. Maintain a high savings rate

Workplace plan participants can increase the likelihood of achieving a desired retirement income level by participating in their retirement plans and making consistent contributions at the highest rate possible. Our analysis provides perspective on the potential range of outcomes, based on various contribution rates across a variety of return environments (see Exhibit 3).

For example, our 3% Saver would have achieved annual inflation-adjusted income of at least 9% of his or her preretirement salary throughout retirement, in 9 out of 10 scenarios (90% confidence level). By comparison, the minimum income replacement levels for our participants with more aggressive savings behavior would have been meaningfully higher—22% (7% Saver) and 48% (6%–18% Saver), respectively (Exhibit 3). Note that this is a minimum level, and the shaded area in Exhibit 3 illustrates the range of potential income replacement rates that a target date strategy investor could experience, given the variability across the broad spectrum of potential investment returns.

Each saver profile may achieve better results than the minimum level noted, depending on the investment performance and return environment during their careers. For example, in approximately 8 out of 10 simulated return environments (75% confidence level), we would expect the 6%–18% Saver to replace at least 65% of his or her salary in retirement. Higher levels of income replacement are possible if investment returns are higher than historical norms (far right of each shaded region), but these outcomes are accompanied by a lower level of confidence.

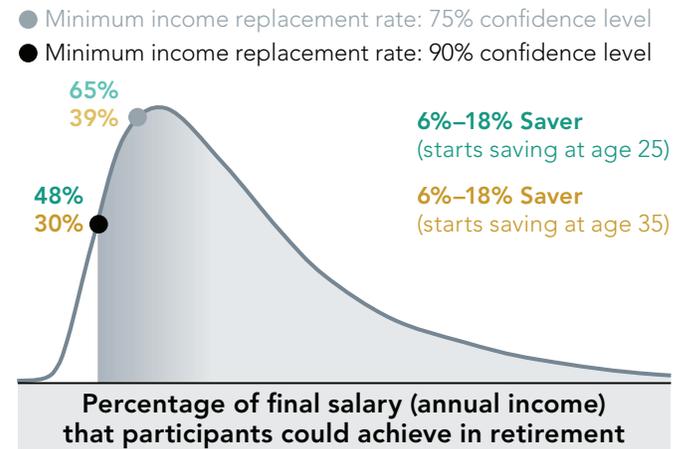
This analysis highlights the importance of maintaining a higher savings rate during the period before retirement. In addition, our analysis showed that higher savings rates were generally associated with a wider range of potential outcomes, owing to the effects of compounding—or contributing more to a return-generating portfolio.

## 3. Start saving as early as possible

Workplace plan participants who choose to begin saving in a target date strategy early in life are likely to experience a higher annual rate of retirement income. For example, a 6%–18% Saver who started contributing at age 25 would have achieved an income replacement level of at least 48% (90% confidence level). If the same 6%–18% Saver waited 10 years to begin contributing, the minimum income replacement rate would fall to 30% (Exhibit 4).

### EXHIBIT 4: Workplace plan participants who begin saving earlier in life are more likely to achieve higher annual income in retirement.

Saving Earlier in Life Can Lead to Higher Retirement Income



The distribution curve is illustrative of the range of attainable income replacement rates (x-axis) and the frequency of attaining a given income replacement rate (y-axis) for a hypothetical investor. The distribution is illustrative of approximately 100,000 randomly generated scenarios. The distribution is derived using stochastic, or randomly generated, simulations and is based on the following assumptions: Starting age, 25 or 35; Retirement age, 65; Retirement planning age, 93. The lifetime strategic asset allocation for the analysis is based on Fidelity’s glide path. The asset classes include U.S. equities, non-U.S. equities, U.S. investment-grade bonds, and short-term debt. The stated income replacement rate represents the minimum real income replacement rate of a hypothetical investor’s experience, with 90% confidence, based on a final pre-retirement salary. For example, in 90% of the simulated scenarios, the “6%-18% saver, starting age 25” would realize a real income replacement rate of 48% or greater. The assumptions for the savings scenarios are: “6%–18% Saver, Starting age 25:”, 6% savings rate beginning at age 25, increasing 1% each year until 18%, 18% thereafter through age 64 (no employer match). “6%–18% Saver, Starting age 35:”, 6% savings rate beginning at age 35, increasing 1% each year until 18%, 18% thereafter through age 64 (no employer match). All Saver scenarios reflect an annual inflation-adjusted salary growth rate of 1.5%. The results do not include the impact of taxes and fees. IMPORTANT: The projections regarding the likelihood of various outcomes are hypothetical in nature, do not reflect actual investment results, and are in no way guarantees of future results. Please see appendix for additional information regarding stochastic simulations and indexes used. Source: Fidelity Investments.

These results underscore the importance of starting to save early in one’s career. The asset allocation mix of a target date strategy typically has greater exposure to asset classes with higher return potential, such as equities, early in the savings horizon. This exposure is important to building wealth via the favorable effects of compounded returns over time. Plan sponsors can help participants begin saving early by considering the adoption of auto-enrollment in their plans.

#### 4. Retire later, if possible

The longer a participant contributes to his or her plan, the more likely he or she will have a higher level of retirement income. There are various reasons that may cause a participant to retire earlier than a planned target date (both voluntarily and involuntarily), but doing so could result in a lower-than-expected level of retirement income. For the 6%–18% Saver, retiring at age 65 resulted in a minimum income replacement rate of 48%. Had the same saver retired three years earlier at age 62, he or she would have ended up with a 41% minimum rate of income replacement (Exhibit 5).

An early retirement shortens the number of years that an employee contributes and extends the retirement funding period. Both the participant who retired early at age 62 and the one who may retire at 65 have a range of potential outcomes, but the potential income replacement is consistently higher across the distribution at later retirement ages.

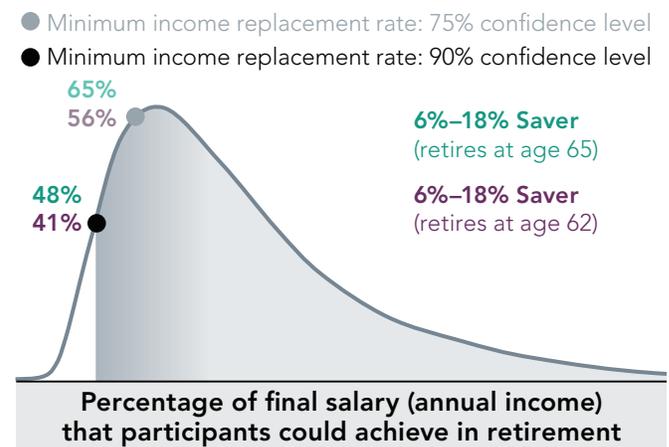
#### 5. Skilled investment management can improve the range of outcomes

Because target date strategies vary widely in their approach to asset allocation, it is important to evaluate and select an investment manager whose strategy provides flexibility to navigate the uncertainty of the capital markets. Understanding the strategy’s objective and its alignment with the objectives of the workplace plan are also important considerations.

More specifically, the glide path of any target date strategy is an active decision made by the manager; there is no industry-wide benchmark glide path. Studies have shown that asset allocation can be a significant driver of returns over time. As a result, plan sponsors and participants should understand a target date strategy’s glide path and its goal. Is the glide path designed to achieve a stated

#### EXHIBIT 5: Workplace plan participants who retire earlier than a planned target date may need to increase their savings earlier in life to maintain a desired level of annual income in retirement.

Retiring Early Can Result in Lower Retirement Income



The distribution curve is illustrative of the range of attainable income replacement rates (x-axis) and the frequency of attaining a given income replacement rate (y-axis) for a hypothetical investor. The distribution is illustrative of approximately 100,000 randomly generated scenarios. The distribution is derived using stochastic, or randomly generated, simulations and is based on the following assumptions: Starting age, 25; Retirement age, 65 or 62; Retirement planning age, 93. The lifetime strategic asset allocation for the analysis is based on the equity roll-down for Fidelity’s glide path. The asset classes include U.S. equities, non-U.S. equities, U.S. investment-grade bonds, and short-term debt. The stated income replacement rate represents the minimum real income replacement rate of a hypothetical investor’s experience, with 90% confidence, based on a final pre-retirement salary. For example, in 90% of the simulated scenarios, the “6%–18% saver, retire age 65” would realize a real income replacement rate of 48% or greater. The assumptions for the savings scenarios are: “6%–18% Saver, Retire age 65.”, 6% savings rate beginning at age 25, increasing 1% each year until 18%, 18% thereafter through age 64 (no employer match). “6%–18% Saver, retire age 62.”, 6% savings rate beginning at age 25, increasing 1% each year until 18%, 18% thereafter through age 61 (no employer match). All saver scenarios reflect an annual inflation-adjusted salary growth rate of 1.5%. The results do not include the impact of taxes and fees. IMPORTANT: The projections regarding the likelihood of various outcomes are hypothetical in nature, do not reflect actual investment results, and are in no way guarantees of future results. Please see appendix for additional information regarding stochastic simulations and indexes used. Source: Fidelity Investments.

objective? What research and philosophy inform the selection of the glide path? Is the investment process flexible enough to engage the uncertainty of the capital markets? What are the resources and infrastructure supporting asset allocation decisions? In addition, plan sponsors should evaluate whether an investment manager considers a range of investors with diverse needs and circumstances across retirement ages, starting ages, savings rates, life expectancies, and other variables.

When choosing a target date manager, some considerations are:

- **Broad and global investment capabilities**, including asset allocation research, global fundamental company research, and quantitative research.
- **Robust risk-management frameworks** to evaluate the market environment and the strategy's asset allocation.
- **A flexible investment process** that can adapt to shifting capital-market environments and the risks that participants may experience over time.

## Final Thoughts

The combination of investment returns and prudent savings behavior can help improve retirement outcomes. As our analysis has shown, a range of outcomes can be evaluated for target date strategy investors in workplace plans, given many variables. There are measures that plan sponsors and plan participants can take to increase the potential for a target date strategy investor to achieve a desired level of retirement income. To summarize:

### Plan participants:

- Pursue a high contribution rate.
- Take advantage of workplace plan savings features to increase savings over time (employer matching funds, auto-increase).
- Start saving as early in life as possible and maintain contributions through the target retirement date.

- Look for target date strategies with deep investment expertise and the flexibility to navigate capital markets.

### Plan providers:

- Identify a target date strategy manager with an investment objective that is appropriate for a broad range of investors, and one with an investment process supported by resources and expertise to be flexible enough to navigate a variety of capital markets.
- Consider offering participant savings features, such as matching funds, automatic enrollment, and automatic savings rate increases.
- Consider target date strategies as a default investment option.

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#### Endnotes

<sup>1</sup> Source: Fidelity investments record-kept data (PWIS DC ex TEM) of 22,100 corporate DC plans and 14.5M participants as of 12/31/16.

<sup>2</sup> See endnote #1.

<sup>3</sup> For many investors, workplace plan assets will be combined with other complementary sources of income (e.g., Social Security, defined-benefit plan benefits, and personal savings) in seeking to achieve an overall retirement planning income replacement rate target.

<sup>4</sup> No income replacement rate is guaranteed by any Fidelity target date portfolio.

<sup>5</sup> Our assumption for the 3% Saver and the 7% Saver is that these participants did not make any changes to the deferral rate over time, and did not participate in an automatic increase feature. The contribution rate reflects a total annual rate considering both participant and employer contributions, executed on the first day of the calendar year. In our calculations, we assumed an annual inflation-adjusted growth rate in salary equal to 1.5%, executed on the first day of the calendar year.

<sup>6</sup> See endnote #5.

<sup>7</sup> In our calculations for the 6%-18% Saver, we assumed an annual inflation-adjusted growth rate in salary equal to 1.5%, executed on the first day of the calendar year. The contribution rate reflects a total annual rate considering both participant and employer contributions, executed on the first day of the calendar year.

<sup>8</sup> Fidelity's "through" glide path may differ somewhat from those of other target date strategies, which could influence the results of the analysis in this article. Stochastic simulation is a mathematical method used to estimate the likelihood of a particular outcome based on historical market performance analysis. Historical performance simulations are conducted to determine the probability that a portfolio may experience a certain minimum level of performance given market volatility. Each stochastic simulation reproduces a random set of results by generating a random return for the scenario. When analyzed together, these results suggest a probability of occurrence. For the purposes of our stochastic simulations, we randomly generate a series of thousands of returns for a given scenario. These scenarios provide a probability that a certain amount (or greater) of assets/income occurs at that level. In conducting our analysis, we used historical index performance to represent asset class returns. Historical returns and volatility of the stock, bond, and short-term asset classes are based on the historical performance data from 1926 through Dec. 31, 2016 from Morningstar. U.S. equities, non-U.S. equities, investment-grade bonds, and short-term debt are represented by the S&P 500<sup>®</sup>, MSCI EAFE Index (for the period from 1970 to Dec. 31, 2016; foreign equities prior to 1970 are represented by the S&P 500<sup>®</sup>), U.S. intermediate-term government bonds, and 30-day U.S. Treasury bills, respectively. **While indexes can provide insight on how asset classes have performed during historical market cycles, they do not take into account key factors such as fund expenses or portfolio manager investment decisions, and should not be considered representative of how a fund has, or will perform.** Index performance included the reinvestment of dividends and interest income. Indexes are unmanaged. It is not possible to invest directly in an index.

<sup>9</sup> For the purposes of this research, the strategic asset allocation (i.e., Fidelity's glide path) was held constant throughout the life cycle; no deviations were made to the glide path during the approximately 70-year horizon.

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