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The Problem with Target Date Funds

Viewpoint of a professional fiduciary

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EXECUTIVE SUMMARY

Almost one-third of 401k plan contributions are going into target date funds, which may also be called lifecycle funds and time dated funds. Is this growth healthy?

- *Are target funds prudent investments for all retirement plan participants?*
- *Do participants truly obtain the optimum investment return with this vehicle?*
- *What should fiduciaries make of the persistent promotion of such funds by investment product marketers?*

This white paper explores the key issues that underlie the integration of target date funds into an ERISA defined contribution plan's investment lineup.

Risk Tolerance Made Too Simple?

Target date funds have a simplistic formula for determining risk tolerance; just decide when a worker wants to retire. For example, if the planned year of retirement is 2019 then a "2019 target date fund" would be selected.

Such a fund assumes that everyone with a ten year time frame before retirement has exactly the same risk tolerance and financial goals. Everyone? Is that true? Absolutely not. Is it prudent portfolio planning? No, it is not.

Common sense will tell you just picking a year to retire should not be the basis for constructing an investment portfolio. The most important information you need to know about a plan participant is their risk tolerance, not which year they plan to retire.

Target date funds assume everyone's tolerance for risk is the same. This makes it easy from an administrative viewpoint but are plan sponsors making a prudent choice their participants?

Even more importantly, are plan sponsors making the right ethical decision in offering an investment to their participants which ignores their individual risk tolerance? Plan sponsors need to find a way to discover the risk tolerance of each of their participants, since this is the most basic requirement before offering any investment.

Target date funds, with their one size fits all approach, violates this rule in the name of simplicity. Not every employee has the same risk tolerance or financial goals as their colleagues. The importance of establishing risk tolerance is, by itself, enough to make everyone think twice about using target date funds as a form of retirement investing.

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Rebalancing in Down Markets

Target date funds not only create the same portfolio for everyone that wants to retire in a certain year, but they also automatically rebalance the portfolio without regard to market conditions.

For example, if a target date fund in 2009 lost value in its equity positions it would rebalance by buying more stocks in early 2010, regardless of market conditions.

An employee invested in such a fund would have no ability to move to a more conservative position during the decline. The actions target date funds take while in a severe bear market will simply make losses greater for an existing portfolio.

This non-thinking approach to market rebalancing is easy to administer, since all portfolios automatically get rebalanced at the same time. Rebalancing in this way can produce dangerous outcomes because it lacks the input needed to react to market developments.

This is another reason why making a financial product that is simple may not be in the best interest of all pension plan participants.

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Are Internal Target Date Fund Investments the Best?

Often the investments inside a target date fund are mutual funds offered by the same investment firm that created it. Is this impartial money management selection? No. It serves the mutual fund company well, but what about the individual participants?

Mutual fund companies are saying you can have any target date fund investment manager you want as long as they are employed by their company and it gets the fees for it.

Consider this…certain investment managers are known to be shareholder friendly due to their low fees. But in target date funds offered by the least expensive managers, you only get access to mostly passive investments.

This helps such firms make money even if the management fees are low. A small percentage of billions of dollars adds up to a lot of revenue for adding no value other than merely tracking a market index.

> "Vendors have a strong incentive to use their information advantage to distort market outcomes in own favor."
>
> *U.S. Department of Labor*

Asset Allocation Strategies Vary

How much should your plan's participants hold in equities when facing retirement in ten years? Does retirement mean they should go to all cash or bonds? Should they hold REITS no matter what the real estate market is doing? Everyone answers these questions differently and therefore different asset allocation models emerge.

Using ten years to retirement as an example, let's assume that for the first five years the stock market performance was awful. A target date fund would rebalance automatically into declining stock values resulting in a string of losses.

Now let's say that five years from retirement the markets turn around and soar. But since we are close to retirement the target portfolio is moving from equities into bonds and cash.

Consequently, we would miss the opportunity to make some of our money back because the target date fund assumes we need to move to cash and bonds as we get closer to our target date. Can you imagine a worse timing scenario for someone who is depending on this money for their retirement?

Putting your retirement plan on autopilot with a target date fund and then hitting a market storm like 2008-2009 reveals the fact that there is no human pilot to back it up. Even airplanes have captains just in case something goes wrong with the autopilot.

Target date funds are set up with the assumption that everything they do is ideal for every participant in the portfolio. That assumption can be appallingly wrong.

The Myth of the Automatic Portfolio

Plan sponsors, administrators, human resource executives and others who are involved in making decisions about the composition of their retirement plans' investments should stop searching for the perfect automatic portfolio for their participants. There is no such thing, and never will be. There are too many variables in the market, risk tolerance parameters, and financial goals of your participants to ever come up with the perfect simple solution.

Target date funds are not the cure-all and, in fact, can be harmful to a pension participant's financial future.

Investing is hard work. It takes time and effort. In order to provide the best retirement future for employees, employers must invest the work and effort needed to avoid costly errors in constructing investment options.

The value of pension participants' assets dropped by trillions of dollars over the last couple of years while Americans stood on the sidelines in shock. Target date funds cost many employees a significant part of their nest eggs that will never be recovered.

This alone should cause the retirement plan industry to rethink its initial infatuation with target date funds. There are better systems and more efficient ways to help your participants plan their retirement futures.

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About the Author

Christine L. Denton is Senior Vice President for Roland|Criss. She oversees our firm's fiduciary audits of pension plans, foundations, and endowments.

Her expertise includes securities analysis; investment strategy formation; fiduciary standards of care under U.S., Canadian, and Australian laws; industry best practices for trustees of ERISA qualified plans, public pensions, and endowments; and fiduciary support standards for investment managers and investment advisors.

She has over 13 years experience advising pension plan sponsors and foundation trustees on their investment oversight responsibilities through prudent processes. Christine has served as an expert witness in disputes representing defendant positions in breach of fiduciary duty claims. Her clients cover the full spectrum of ERISA qualified plans, university endowments, and health care foundations.

Christine oversees Roland|Criss' audits of investment advisors, investment managers, and other fiduciary organizations for CEFEX's certification programs. She has personally conducted or supervised over 70 audits of candidates for CEFEX certification in the U.S., Canada, Australia, and New Zealand.

Ms. Denton is also a guest lecturer at trade conferences and workshops. In addition, she developed many of the software solutions used in Roland|Criss' fiduciary risk management program - FiduciaryPLUS™.

During her tenure with **Roland|Criss**, Christine served as the Executive Director of the Trustee Training Institute. It was established in 1998 as a joint venture between **Roland|Criss** and a top tier financial services firm.

Prior to joining Roland|Criss, Christine was a financial analyst with LFG/Sky Chefs Corp. in its treasury and asset management group.

Christine earned a Bachelor's degree in Finance from Baylor University. She is an Accredited Investment Fiduciary Analyst™ (AIFA®), which qualifies her to conduct and supervise independent fiduciary reviews for those persons concerned about their responsibilities for investing the assets of endowments and foundations, ERISA qualified plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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