TARGET DATE ANALYTICS LLC

II. Are target date funds a bad idea?

The second in a series of articles about target date funds, written to give badly needed perspective to the critical issues faced by target date investors, by plan sponsors and their advisors.

When the assets in target date funds (TDFs) began to grow significantly (see Installment I. in this series, A brief history of target date funds), the very idea of an asset allocation fund that would change over time came under attack. At the end of 2008 when the average 2010 fund had lost over 23%, the criticism redoubled. While some of this criticism can be dismissed as mere carping by advisors afraid of losing market share, some of the criticism has merits. In this issue we examine the criticisms with a view to answering the question, "Are TDFs a bad idea?"

The most common complaint about TDFs is generally expressed as follows, "No fund based solely on years-to-retirement can be the best investment strategy for every participant with the same number of years to retirement."

We agree. However, TDFs don't claim (or shouldn't claim) to be the *best* choice for *every* investor. TDFs are justified merely by providing a *rational* investment strategy to *most* defined contribution investors. It wouldn't be very efficient to offer an distinct, customized portfolio for each one of the 154 million employees[1] in America, so we look for factors we can use to aggregate investors into groups or cohorts. TDFs use years-to-liquidity as the aggregating factor.

The objection to using time to aggregate investors is often expressed in indignation at the supposed offense to our individualism; i.e., "not all 45-year olds are the same." Of course that's true, but it is not always true from a portfolio management perspective. Consider a 25-year-old, for whom we can assume 40 years to retirement. That single piece of information is more powerful as a portfolio construction factor than all other factors combined.

Those objecting to TDFs always mention other factors that should be considered: most notably, outside assets and risk tolerance. Let's consider those factors for a 25-year-old.

1. Most 25-year-old participants in 401(k) plans have no meaningful outside assets; although a few do. If we tried to aggregate all participants based on outside assets we wouldn't get very

far. Should we reject an efficient portfolio strategy (TDFs) for the majority who don't have outside assets because it wouldn't be optimal for the few who do? Of course not.

2. Risk tolerance is a psychologistic assessment, self-conducted by investors using pseudo-scientific questionnaires. And not only is the original determination questionable, but the results are famously unstable. Aggressive investors in bull markets suddenly become conservative investors when the market takes a turn. Conservative investors eventually re-think their conservative posture during extended bull markets. We don't know if the risk tolerance assessments for 25-year olds are any better or worse than for other age groups but we do know the questionnaire approach is weak for all investors. Clearly we can't use risk tolerance assessments as the primary aggregator. There are those who advocate using both years-to-liquidity and risk tolerance but they generally don't deny the primacy of the time factor.

The criticism about aggregating all 25-year olds doesn't hold up. Does it hold up for 65-year olds? Yes, it does. Older participants are significantly different from one another from a portfolio management perspective. By the age of say 55, the differences between participants outweigh their age-based similarity. For those participants who have regularly contributed to their retirement funds, account balances will have grown substantially. And while young investors all share the same objective, to grow their account balances early in the accumulation phase and then hold onto what they've accumulated; older investors, as they begin to plan for their distribution phase, have widely divergent objectives. A single aggregated strategy will no longer do. Some will cash out and buy an annuity. Others will pay down debt, pay uncovered medical expenses or hire an advisor to build a real distribution portfolio (unlike the extended glidepath models calling themselves distribution portfolios).

That brings us to another point. Some of the criticism of TDFs is based solely on the notion that every investor should use the services of a personal financial advisor. But of course we know there aren't enough qualified planners to go around, and if there were how would investors pay? Holders of tiny account balances (as are most at the beginning of the accumulation phase) cannot afford any meaningful fee for the service. It would be better to let the TDFs do the work over the first thirty years or so of the accumulation phase, and then, to encourage participants to seek the help of qualified planners, as the target date approaches, as the assets at stake are more substantial, and as investors can afford to pay without depleting their entire account balances.

Unfortunately, most TDF manufacturers extend their glidepaths into the distribution phase, ignoring the differences among their older investors, precluding the multiple options investors might pursue, abandoning the risk-management duties of TDFs, causing the unsustainable losses like those incurred by 2010 fund investors in 2008, and earning every bit of criticism laid on them.

This is the final criticism we'll consider. Anyone could be excused for concluding that, given the devastating losses in 2008, TDFs are indeed a bad idea. However, as noted above, these losses occurred within TDFs that had extended their glidepaths into the distribution phase and were holding far too much equity at the target date to be prudent. Those actions are not functions of fundamental TDF concept; they result from the corruption of target date investing (emphasis on the words "target date").

Let's return to the fundamental TDF concept. The basic principle is simple, sound, and based on generally accepted portfolio management principles. The amount of time to liquidity affords the portfolio manager a gauge for how much growth can be sought and how much risk can be taken; increased growth potential is accompanied by a corresponding increase in risk. And to remain faithful to the fundamental TDF concept, the risk of loss must be significantly reduced as the target date nears (and the size of the portfolio grows.)

We conclude that target date funds are *not* a bad idea; they are rather a good idea, an elegant solution to the demand for appropriate asset management for most DC investors, but this elegant solution is often corrupted by investment managers seeking to retain assets within the TDF too long, thereby requiring exceptional due diligence skills on the part of advisors and sponsors to find good target date funds.

In future installments of this series we will provide selection and monitoring tips for plan sponsors and advisors.

Target Date Analytics LLC

Next article in the series: III. Common myths and misconceptions about TDFs

To view earlier installments in this series, or for more information about target date funds, please visit our website: www.ontargetindex.com/articles

[1] Bureau of Labor Statistics, Current Population Survey, 2010