This Decisive Demographic Drives Target Date Fund Selection

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Fiduciaries are instructed to choose their target date funds on the basis of workforce demographics. So says the Department of Labor and prominent ERISA attorneys like Fred Reish and Marcia Wagner. The demographics that are frequently cited include salary, savings and age. In principle, demographics are supposed to lead the fiduciary to an appropriate glide path: the establishment of appropriate risk for young people and how that risk should adjust through time as an employee ages.

Focusing on the Most Important Demographic

This is a complex mandate that can be substantially simplified, following Einstein's advice to "Make everything as simple as possible, but no simpler." Simplification begins with noise reduction. Our sole focus should be on those who default their investment decisions, since most assets in TDFs are there by default. **What is the distinctly decisive demographic that characterizes defaulted participants? It's a lack of financial sophistication.** This can be confirmed with a financial literacy quiz, but the mere fact that they can't make an investment decision is strong evidence. This doesn't make them dumb. Will Rogers said "Everyone is stupid but about different things." Most individuals outside the financial profession know little about investing. Educating them is not the answer. An appropriate glide path is.

Making an Appropriate Risk Decision

But what is appropriate for the naïve? If 2008 taught us anything it's that TDF participants believe they are safe, especially as they near retirement. Participants in 2010 funds had no idea they could lose 25% of their savings, and they will never understand what happened. In other words, the risk tolerance of the unsophisticated is very low. **When you're walking in the dark every stumble is scary**. The naïve need to be protected, especially as they end their careers. This argues for conservatism near the target date. A survey of investment consultants by the Center for Fiduciary Due Diligence reveals a very low risk tolerance on behalf of those near retirement; a 5% loss is the maximum to be tolerated.

Choosing a Target Date Fund

How safe should participants be? Therein lies the big disagreement among TDF providers. Equity allocations near the target date range from 20% to 75%, with the balance of assets mostly in long term bonds, which are of course risky too. The decisive demographic argues for the low end of this range, but there are even safer designs.

My patented Safe Landing Glide Path® is entirely in safe T-bills and short term TIPS at the target date. It's the ultimate in safety. You can judge whether this is too safe, but please be aware that this safety is intended to be in place for just the last year of employment, after which most withdraw their accounts. It is not intended to be an asset allocation in retirement. My view is that you can't be too safe when it comes to protecting the vulnerable, the unsophisticated. Bear in mind that before the Pension Protection Act of 2006 the common default was cash.

Whatever decision you make, it should be documented in an Investment Policy Statement. You should document your risk decision and objectives because it's the prudent thing to do.