

The good, the bad and the ugly of target date funds

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Target-date funds are good because they provide a simple and safe option to those who might otherwise make bad choices. These funds are attracting significant assets and are likely to continue to do so, due in part to their meeting Department of Labor guidelines for qualified default investment alternatives. But target-date funds could be bad if they fail to provide reasonable results, like target pay replacement in retirement. And they could be ugly if investors bounce in and out of them as they have with other investment options.

Target-date funds have no guarantees; they provide a “set it and forget it” investment pattern that should serve the typical investor well. These funds are aggressive at first and then become more conservative through time as the target date draws near. The idea is to take more risk, in the hopes of higher return, when the horizon is long and account balances are low because there is time to recover from losses through both savings and future returns. Then as assets accumulate and the target date approaches, asset protection takes precedence over performance; there is a shift in objective.

In simple terms, every target-date fund incorporates three features: risky assets, protective assets and a glide path. This structure sets apart the good, the bad, and the ugly of target-date funds.

Risky assets

For the risky asset, a good choice is the most diversified portfolio that can be assembled. Modern portfolio theory tells us that diversification provides the best returns for the least amount of risk and that the ultimate diversification is the “world portfolio” comprising all assets in the world. This world portfolio includes stocks, bonds, real estate, natural resources, etc. No one really knows the

composition of this ideal, but it is a goal worth striving for.

A bad choice of risky assets is not diversifying. For example, a portfolio of only stocks is not diversified even if those stocks are global. The narrower the scope of assets, the poorer the diversification, which undermines the risk-reward relationship.

Also bad is the exclusive use of active managers based on the promise of outperformance, because no one should make this promise. Outperforming passive investments is a hope that is not confirmed by actual experience. Most multimanager programs fail to deliver value added. Some multimanager fund providers have even argued that it's a breach of fiduciary duty to use only passive investments because you leave active manager value added on the table. This is absurd.

An ugly choice is using all active funds provided by the same management company. Skill is hard enough to find when the search is open to all. Limiting the investment team to just the family is not likely to produce good results.

Protective assets

A good protective asset preserves not only principal but also purchasing power. After all, the end game is to afford a reasonable standard of living in retirement, which means we need to be able to buy goods at future inflated prices. Variable-rate bonds, Treasury inflation-protected securities and Treasury bills are examples of good protective assets.

A bad choice is long-term fixed-rate bonds because they are risky and decrease in value when inflation increases. In fact, these bonds should be included in the risky asset pool.

An ugly choice of protective asset is U.S. long-term fixed-rate bonds managed by the target-date fund provider.

Glide path

A good glide path strives for high returns in the early years when the investor should be less risk averse because there is plenty of time to recover if necessary and asset balances are low. Investor risk aversion should increase as account balances grow and the target date nears.

The two key decisions a target-date provider must make are when to start applying the brakes, and how forcefully to apply them. One timing decision rule is to wait until the horizon is short enough to have a risk of loss. My research indicates that

it is highly unlikely that an investor in a well-diversified portfolio of risky assets will lose money over a 10-year period. In other words, an investor who will stay with the program for 10 years is highly likely to make money. Accordingly, this risk-of-loss rule argues the brakes are first applied at 10 years before the target date.

The magnitude of transfer from risky to protective assets can be determined using the principles of liability-driven investing. Sufficient assets are set aside in the protective asset such that even if the worst-case risky return is realized over the horizon, the total account balance is insulated from purchasing power loss. This structure leads to a non-linear glide path because transfers increase geometrically.

A bad choice of glide path is applying the brakes too soon, sacrificing performance, or too late, jeopardizing asset values. Some have argued that asset protection should be provided early in the fund's life cycle to keep the investor in the game. Others argue an opposite case: that the brakes should be applied as late as possible, and they should only be applied a little. These providers see the fund at target date morphing into a distribution fund. Target-date funds do not close down at target date; they continue as “current” funds.

Attempting to protect asset values throughout the life cycle is a very expensive proposition, and is tantamount in early years to insuring the house on the mountain against floods. Leaving the brakes off, or almost off, exposes the investor to unnecessary and unwarranted risks. So far the competition for target-date business has been based on performance and has led most to favor a very gentle application of the brakes, leaving the target-date fund in a substantial risky asset allocation at target date.

An ugly glide path choice evolves from this performance horse race. Exposing the investor to too much risk at target date could be catastrophic. The motivation of supporting the distribution phase is probably not in the best interests of the investor. All sorts of distribution alternatives are springing up to accommodate a diverse set of objectives and circumstances in retirement. These distribution choices are much more complicated than the accumulation decisions, so target-date funds should stick to just the single objective of accumulation, which is in keeping with the appeal of simplicity.

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