The Perfect Fit for One-Size-Fits-All Target Date Funds

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If the shoe fits, wear it. Daniel Defoe, poet

There are many criticisms of target date funds, but the primary disparagement is that they are one-size-fits-all. After all, we are all unique, with divergent financial situations, needs and wants. But we all have a single common objective, a one-size-fits-all objective that can and should be served by target date funds. The problem is that there is only one target date fund glide path designed to achieve this universal objective, and it is a secret. We'll let you in on the secret in this article. There is a perfect fit for target date funds, and it's obvious once you see it – it's a real Ah-Ha moment.

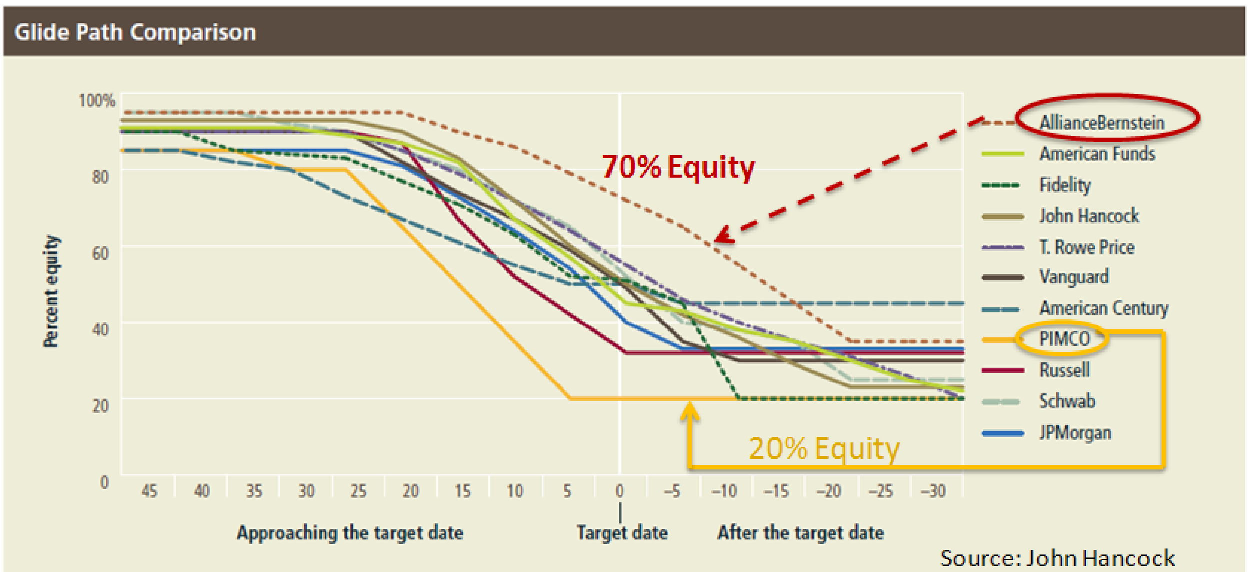
Risk is the possibility of failing to achieve objectives

There are two indisputable truths in defined contribution retirement savings:

1) Saving enough is critical to retiring with dignity.
2) There is a risk zone spanning the 5 years before and after retirement during which losses can materially disrupt retirement lifestyles, even if savings are sufficient. You only get to do this once. No do-overs.

These facts are largely ignored when it comes to target date funds (TDFs). Specifically, target date funds are designed to make up for inadequate savings by earning substantial investment returns through high equity exposure, even at the retirement date. The typical target date fund is invested 50% in equities at the target date. The stated objectives of TDFs are to replace pay and manage longevity risk, but that's just the hype that lets fund providers sell product rather than solution. Please note that you will not find these objectives in prospectuses or factsheets – they're just in sales materials. Most importantly, an investment "glide path" cannot reasonably be expected to replace pay or manage longevity risk, so the probability of failure is high – high risk. See our short movie at **[The Sad Comedy of Target Date Funds](#).** The right course of action for achieving these objectives is to save enough. These stated TDF objectives are mere hopes, and certainly are not the universal "fit" for this one-size-fits-all.

Consequently, the industry doesn't agree on the appropriate risk exposure near the target date. It's no surprise that bond shops are mostly bonds (80%) at the target date while equity shops are 80% equities, as shown in the following graph:



Actions speak louder than words. Profits are the goal.
Equity shops pitch equities. Bond shops pitch bonds. What's best for the participant?

The target date is critical for profits since that's when account balances are their highest. It's also critical to participants because lifestyles are at stake. There is a conflict of interest. Fund companies say the wide dispersion of equity allocations at target date is because of demographics – under savers need more risk than the wealthy. Don't believe it. There is a better way, revealed in the next section.

The Secret is Revealed

Capital preservation is the universal objective of TDFs, the "perfect fit" for this "one-size-fits-all." It's the one objective that we all have in common – don't lose our money. Furthermore, we all want to earn as much as we can on our investments, as long as we avoid unjustified risk that could lose our money, especially as we near retirement. Accordingly, the presumption for target date fund design should be that participants have saved enough to support a lifestyle that is acceptable to them. Some may plan for a life in a modest hovel while others see a yacht in their future. It's all the same. A plan is a plan. The only "demographic" that matters is the lack of financial sophistication on the part of those who are defaulted into TDFs; they need to be protected, rather than exposed to substantial risk, especially at the target date. This is the objective of the patented Safe Landing Glide Path® (SLGP). The Ah-Ha moment in retirement savings is to save enough and protect it from loss, noting that "enough" is an individual decision.

The SLGP is designed to treat each invested dollar as special. Some dollars are decades away from the target date, and some are close to the end. The objective is to grow each dollar from today to the target date so that it will be at least a dollar plus inflation at the target date. Investments that have many years to reach the target date are invested in a broadly diversified world portfolio encompassing global stocks, global bonds, global real estate, global commodities, and other diversifying assets. We assess that there is little risk of loss on this portfolio if it is held for 15 years or longer, so the brakes start to be applied at 15 years to the target date. Then we solve for the worst-case loss from today to the target date, and place sufficient amounts in a "reserve asset" such that protection is provided against the worst-case loss. The reserve asset is 90-day Treasury Bills and Treasury Inflation-Protected Securities (TIPS). This protection is liability-driven investing (LDI), where the "liability" is the current account balance, which we do not want to lose. The LDI discipline leads to 95% in reserve assets at the target date, a very safe position.

Some say this is too safe, but it is just right when you consider the universal objective.

Protect

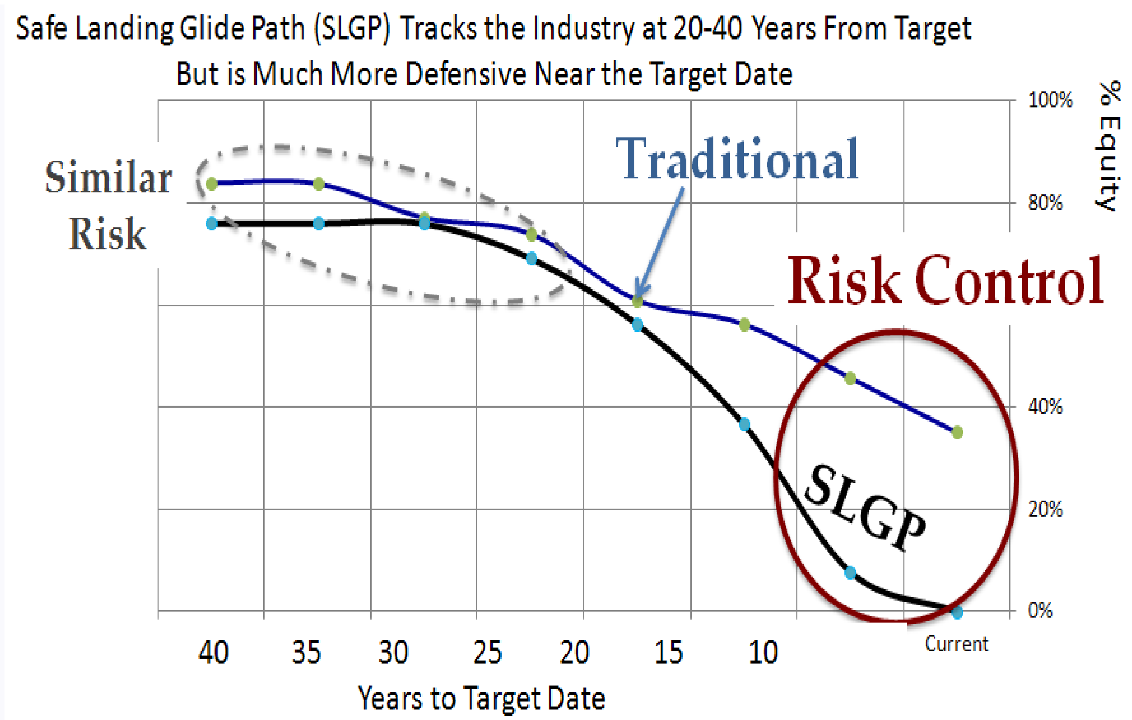
Prior to the Pension Protection Act of 2006, the most common investment default was very safe cash and stable value, which was probably too safe for younger employees but just right for those nearing retirement. But now the risk pendulum has swung too far for those nearing retirement. 2008 is all the proof we need.

Contrary to popular participant need and belief, TDFs do not protect the vulnerable from equity loss. They sure didn't in 2008, and nothing has happened to change that. Most participants in TDFs are defaulted into this product, which means that most participants rely upon their employers to do the right thing by protecting savings, especially near retirement (even though they are not). The Center for Fiduciary Due Diligence recently surveyed investment advisors regarding the protection of assets for those nearing retirement. The majority of respondents want no risk of loss in their TDFs near retirement. The unfortunate disconnect is that the majority also believe that current equity exposures are about right, suggesting that 2008 is perceived to be an unrepeatable anomaly, since 45% in equities suffered 25% losses in that year. Exacerbating the current downside, TDFs are invested in long term bonds at the target date, which are at risk if we see increases in interest rates, as is likely.

By contrast, the perfect fit SLGP integrates the tenets of Modern Portfolio Theory (MPT) with the disciplines of Liability Driven Investing (LDI). Yes, this one-size-fits-all-set-it-and-forget-it glide path is designed to achieve the straightforward universal objective of preserving accumulated savings. The SLGP is a concept, a blueprint, for target date funds. It's like an "ideal gas" in physics. It is not a product *per se* – you can't buy the SLGP target date fund. But you can design a TDF to follow the SLGP. For example, the SMART Funds® are collective investment trusts that follow the SLGP, offered by Hand Benefit & Trust, Houston.

Importantly, the emphasis is placed on safety, as it should be, so asset allocation at target date is mostly TIPS and T-bills. The appropriate mission of a TDF is to get the beneficiary safely to the target date. Attempts to extend the mission beyond target date lead to the "hope" problem and ignore the fact that most withdraw their accounts at retirement.

This prudent Safe Landing Glide Path is in line with the industry at long dates but moves away from the pack to safety as the target nears, as shown in the next graph.



Fiduciary Duty

You may feel that it's OK to ignore these truths because everyone else is ignoring them too, but everyone may be breaching their fiduciary duty. We won't know until we know, but class action lawsuits are a real possibility, in which case it will become clear that "no misery" is preferred to "misery loves company." Fiduciaries are exposed to lawsuits because they have the duty of care, so they are obligated to actually vet their TDF selections and to establish objectives that are truly in the best interests of participants. It's important to recognize that default investments are employer-directed rather than participant-directed, so a higher duty of care applies, warranting a separate statement of investment policy. Fiduciaries are duty bound to seek solutions rather than settling for high-risk products that are oblivious to history. Ignoring the past (especially 2008) and hoping it's different the next time is not an option, and it's certainly not an enlightened view of risk management.

The patented Safe Landing Glide Path® is the only choice for enlightened fiduciaries, even though it remains a secret. The objectives are:

(1) Don't lose participant savings, and
(2) Make as much as you can but don't lose participant savings

Now you know the secret. You can learn more at www.TargetDateSolutions.com. Please tell everyone.