Finding the Sharpshooters of Target Date Lifecycle Funds

By Ron Surz, President, Target Date Solutions,
949/488-8339 Ron@TargetDateSolutions.com

The Department of Labor's (DOL's) new rules for Qualified Default Investment Options (QDIAs) advance three investment options: Target Date Funds, Balanced Funds and Managed Accounts. "Managed Accounts" in this context means that a service provider creates diversified portfolios of the plan's mutual funds (and/or other offerings) on behalf of the participants. Managed accounts hold the most promise for advisors but they require adherence to an audited prudent investment process, a process that could take years to achieve scale. Thus, Target Date Funds (TDFs) are the immediate play. Advisors will be called upon to find the best TDFs, the sharpshooters. But unfortunately, or perhaps fortunately for the opportunistic, current offerings are not as good as they could be. The target date industry is still in its infancy and is likely to evolve very rapidly, if for no other reason than the probable stampede into these funds. The potential growth in assets committed to target date funds over the next 5-10 years is astounding. For example, at year-end 2006, there were 168 distinct target date mutual funds with $109 billion in total assets (if counting all share classes, the total number of funds was over 1,200). As of October 31, 2007 there were 226 target date funds with $164 Billion in assets. This represents a 35% increase in the number of funds and a 50% increase in total target date fund assets in just 10 months.

Even so, the ability to separate the wheat from the chaff is extremely difficult, primarily because there are no good yardsticks for gauging performance. That is why we formed Target Date Solutions (TDS). TDS's mission is to identify best practices in TDFs, and to create glide paths that adhere to these practices. Importantly, we've designed our glide paths to be investible and not just theoretical. You may disagree with some of the specifics, but you will agree that the resulting benchmarks are just what the industry needs.

Target date funds have no guarantees; rather 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. As assets accumulate and the target date approaches, asset protection takes precedence over performance; there is a shift in objective. An advisor's choice of target date fund family is driven by branding, fees and performance expectations. Branding and fees are straightforward, and may even override performance, but best practices are primarily focused on performance.

In simple terms, every target date fund incorporates the following three components:

1. Risky asset pool
2. Protective asset pool
3. Scheduled shift from risky to protective through time called a glide path

Each TDF is unique in its structure of these three components. These differing structures set apart current TDF offerings and establish the template for best practices. Advisors should seek out the sharpshooters in all of these three components.

Risky asset pool

The best choice of risky assets is a diversified portfolio. Modern Portfolio Theory (MPT) tells us diversification provides the best returns for the least amount of risk and 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 worthy goal.

The choice of active or passive managers is secondary to broad diversification, but if active managers are employed preference should be given to open architecture, where the advisor has complete flexibility in manager selection. Skill is hard enough to find when the search is open to all. Limiting the investment team is not likely to produce results.

Protective asset pool

The best protective asset preserves not only principal but 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 bonds (TIPs), and Treasury bills are examples of good protective assets.

Long term fixed rate bonds do not work well as a protective asset because they are risky and decrease in value when inflation increases. In fact, these bonds should be included in the risky asset pool.

Glide Path

The best 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 that a target date provider must make are (1) when to start applying the brakes, and (2) how forcefully. One timing decision rule is to wait until the horizon is short enough to have a risk of loss. "Loss" in this context should be interpreted relative to the riskless asset, which, as I pointed out, could consist of TIPS or Treasury bills. It is highly unlikely that an investor in a well diversified portfolio of risky assets will underperform Treasury bills over a 20 year period. An investor who stays with the program for 20 years is highly likely to reap the reward for taking risk. Accordingly, this risk-of-loss rule argues that the brakes are first applied at 20 years to target date.

The magnitude of transfer from risky to protective asset should be determined using the principles of liability-driven investing (LDI). 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 exponentially. Here's an example. Let's say we're 20 years from target date and our estimate of the worst case unannualized real return (net of inflation) on risky assets is -5%. And let's also say that TIPs are priced to earn a 2% real return per year so over 20 years this would compound to more than a 45% real return. To protect against loss we want -5(1-X) + 45X = 0, where "X" is the amount invested in the protective asset. In this case you can verify that X is 10%, so we move 10% of assets out of risky and into protective. As the time to target date shortens the worst case risky asset loss increases and the cumulative return on the protective asset decreases, so the amount in the protective asset increases at an increasing rate, ultimately reaching 100% at target date.

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. This is dangerous. The motivation for higher risky balances at target is that the "current" fund morphs into a distribution fund. But this is 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 complex 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.

Also, some providers have engineered glide paths that are designed to react to current market conditions, also known as market timing. This reminds me of my first job, designing infrared countermeasures for Northrop. Our equipment protected US aircraft by jamming heat seeking missiles. The protocols I worked on were passive because they were always on, continuously sending out false

heat signatures to potential attackers. An alternative approach is reactive, initiating countermeasures when a missile launch is detected. Both approaches have plusses and minuses. The passive approach offers greater protection but at a cost in aircraft performance. The active approach is riskier, with an obviously high cost in the event of failure, but many pilots preferred to take this risk to gain aircraft efficiency. The timing approach to target date glidepaths is like the reactive approach to missile jamming; long run performance expectations ought to be higher to compensate for the risk of catastrophe.

Conclusion

We at Target Date Solutions (TDS) have constructed the Safe Landing Glide Path that follows the best practices described above. We expect that this approach will be difficult to beat. Time will tell. Be aware that these glide paths are not just hypothetical; they are totally investible. Everyone can actually hold the Safe Landing Glide Path.