Cruisin' for a Bruisin' With Target Date Funds:
5 Reasons Why TDFs Should be Safer

- Despite their popularity, there's something seriously wrong with target date funds.
- Logic argues for greater safety at the target date than is currently being provided.
- Surveys argue for greater safety as well, although no one seems to get the connection.

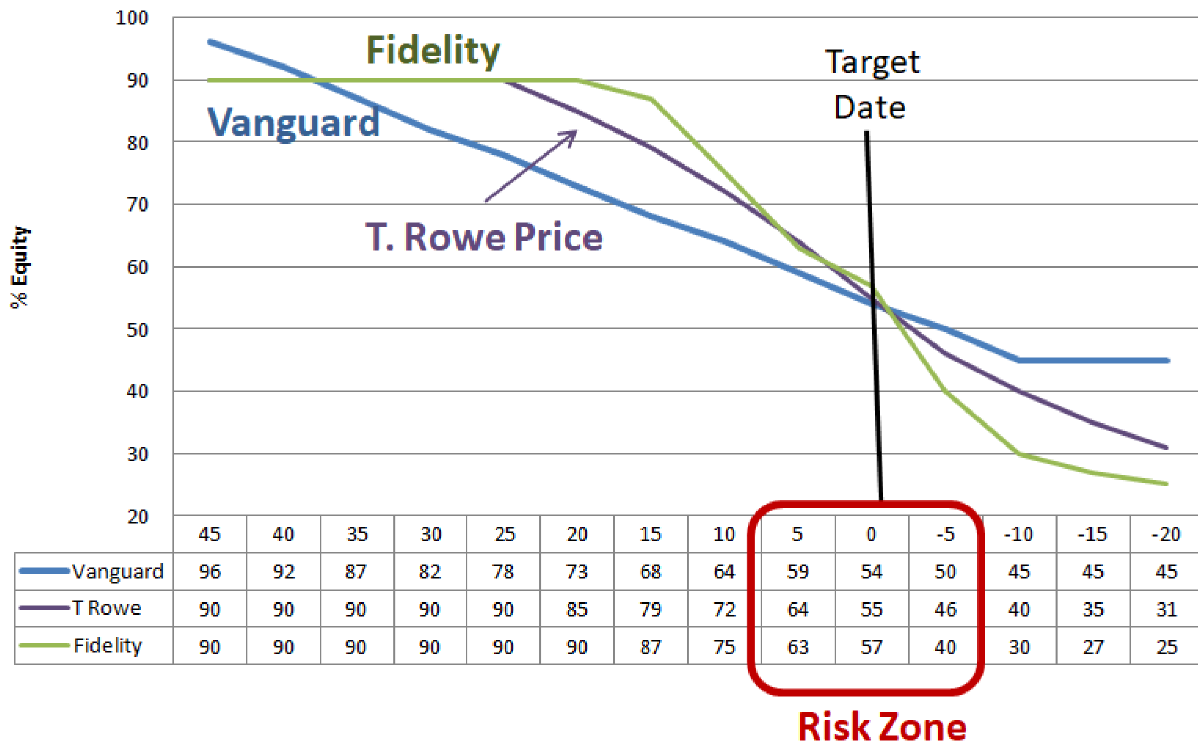
"Cruisin for a Bruisin" is a popular song from the 2013 Disney Channel film "Teen Beach Movie." The chorus goes like this:

So don't stop, stop the music!
We ride fast like a bullet
We do anything we want, anytime we want

Oh Yeah! Oh Yeah!

Most might not see it this way, but target date funds exhibit this devil-may-care attitude at their target date, primarily because the risk is born by investors, not fund companies. Beneficiaries ***ride fast like a bullet*** while fund companies get paid a premium for higher risk regardless of the outcome. Beneficiaries don't feel like bullets until they hit the wall of market crashes.

Sure, TDFs are less aggressive at the target date than they are before that date, but they're still very aggressive, with one foot on the brake while the other stomps the accelerator. The Big 3 TDF providers -- Vanguard, T Rowe Price and Fidelity -- "***do anything they want, anytime they want***" because they own the TDF market as an oligopoly with 63% of this $1.7 trillion treasure trove. Here's a graph of what they do:



	45	40	35	30	25	20	15	10	5	0	-5	-10	-15	-20
Vanguard	96	92	87	82	78	73	68	64	59	54	50	45	45	45
T Rowe	90	90	90	90	90	85	79	72	64	55	46	40	35	31
Fidelity	90	90	90	90	90	90	87	75	63	57	40	30	27	25

The Big 3 are all about 55% in equities during the Risk Zone than spans the 5 years before and after retirement. This is actually riskier than the exposure in 2008 that lost 30%. The Risk Zone is important because account balances are at their highest and Sequence of Return Risk starts when withdrawals begin.

In the following we present 5 reasons that this 55% in equities in the Risk Zone is way too high, and should in fact be no more than 20%.

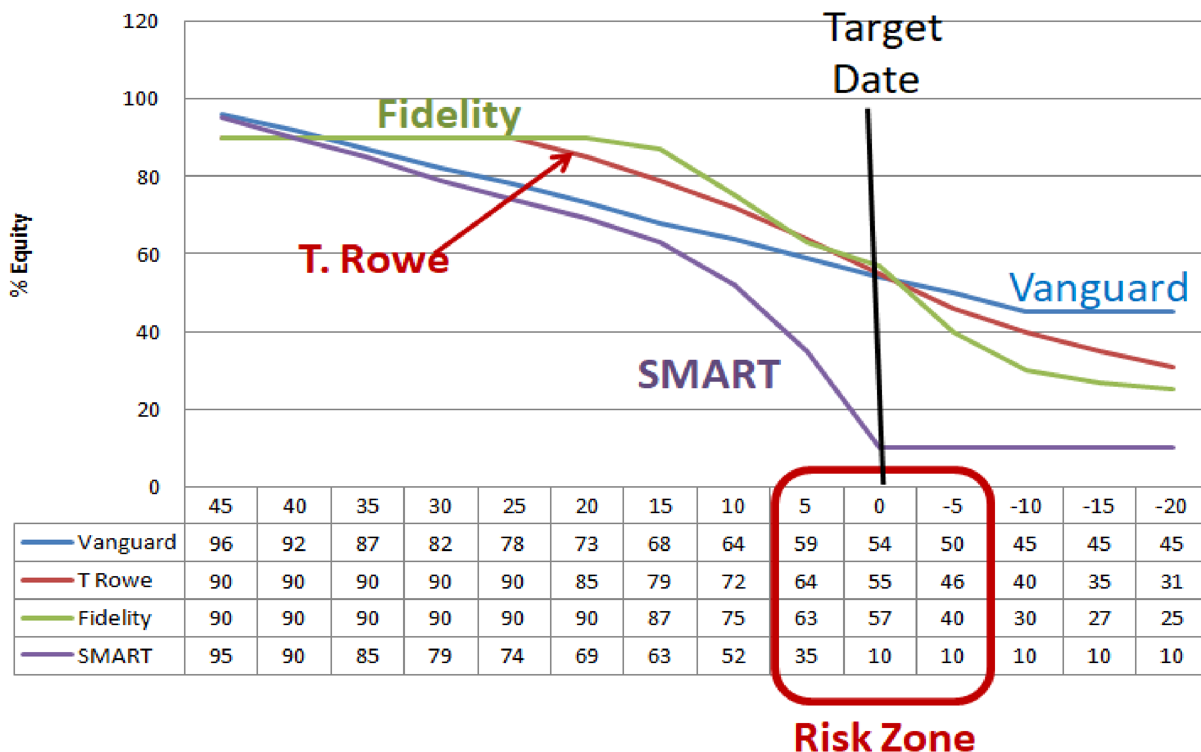
Reason1: Reasonable Objectives

Fiduciaries should set the objectives for their TDFs, but this is not happening. Rather, fiduciaries are basing their TDF choice on limiting their liability. They believe that (1) any qualified default investment alternative (QDIA) will do and (2) you can't go wrong with the Big 3 because everyone else is using them. This is a breach of the Duty of Care.

This Duty requires that fiduciaries try to select the best on the basis of criteria that best serve the beneficiaries. That's simply not happening.

So what objectives should fiduciaries establish? TDF providers say they've designed their products to replace pay and manage longevity risk, but these are mere hopes. Objectives without a reasonable chance of achievement are mere hopes. Saving enough is the only way to replace pay and manage longevity risk, and hoping that you can make up for inadequate savings with investment returns is not a prudent choice. The Big 3 are 55% in equities in the Risk Zone because they have chosen growth over safety as a means to make up for inadequate savings. Their foot is mostly on the accelerator.

By contrast, a reasonable objective is to get participant savings safely to the target date intact, and to earn a reasonable return on those savings. The Hippocratic Oath of TDFs should be "Don't lose participant savings." There should be just one foot at the target date and it should be on the brakes. The SMART Target Date Fund Index is designed to achieve this objective, and looks much like Vanguard until it reaches the Risk Zone, at which time it moves to defend, reducing equity exposure to 10% at the target date and beyond, as shown in the next exhibit:



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SMART	95	90	85	79	74	69	63	52	35	10	10	10	10	10

Reason 2: Demographics

In its 2013 TDF tips the DOL recommends that TDFs be selected to match workforce demographics. This has led to the growing popularity of "Custom" TDFs, which are purported to tailor a glide path to participant demographics. But there is only one demographic that all TDF participants have in common -- lack of financial sophistication. This demographic argues for the protection of the clueless. These folks need to be safe, especially in the Risk Zone. Like the Big 3, Custom TDFs are generally not very safe in the Risk Zone, but they should be.

Reason 3: Beneficiaries Want to be Protected in the Risk Zone

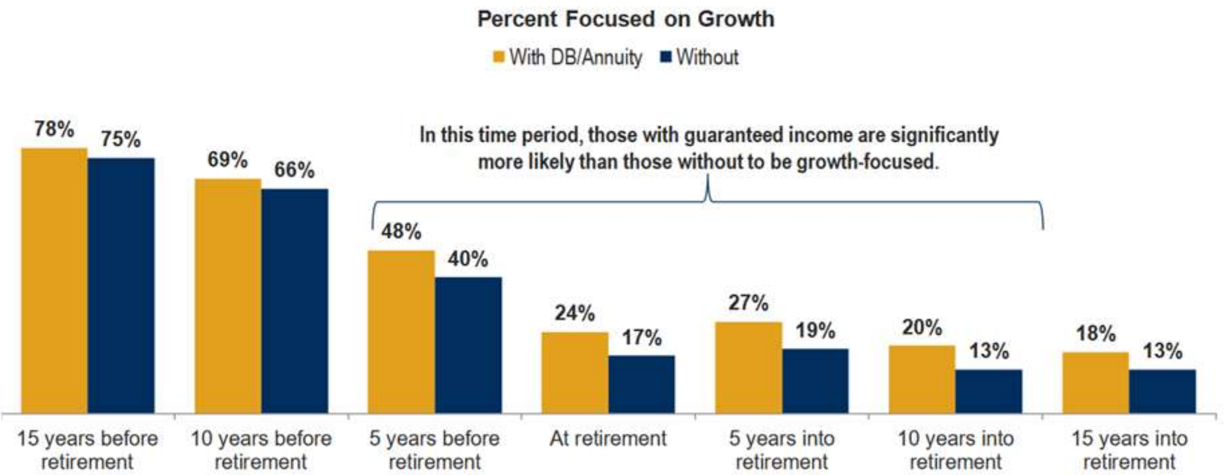
Beneficiaries want to be safe in the Risk Zone, and may think that they are, although they are not. A recent MassMutual Retirement Savings Risk Study examines beneficiary risk preferences in 401(k) plans. The methodology is as follows:

> *On behalf of MassMutual, Greenwald & Associates, an independent research firm, conducted an online survey that included 804 pre-retirees and 801 retirees. Respondents were drawn from ResearchNow's online panel. To qualify for the survey, all respondents had to be at least 40 years old.*
>
> *Pre-retirees were required to have a household income of at least $40,000, work full-time for a private sector employer, and be participating in that employer's DC retirement plan.*
>
> *Retirees were required to have total investable assets of at least $100,000. They had to be retired from a private sector employer and participating in that employer's DC retirement plan at the time of retirement.*

One of the most informative tables in the report shows beneficiary preference for safety over growth in the "Risk Zone":

Beneficiaries Want to be Protected in the Risk Zone

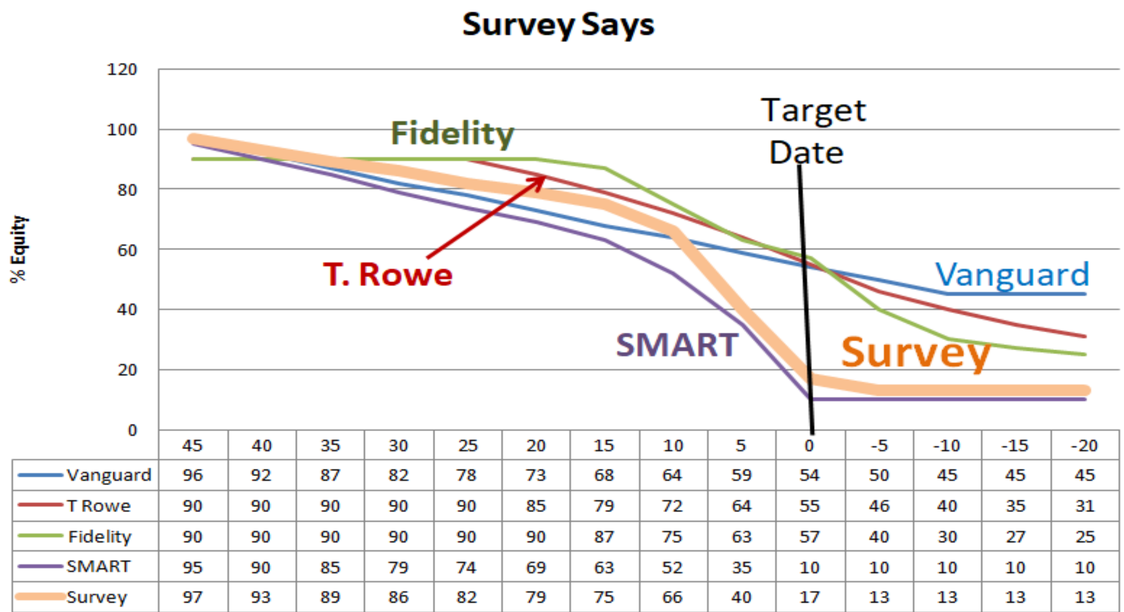
Pre-retirees and retirees with guaranteed income suggest that have or will employ the same investment strategy as those without when retirement is 15 years away and 10 years away, but at 5 years prior to retirement, they become more growth-focused than those without and remain that way until 15 years into retirement.



Source: Mass Mutual

At 15 years to the target date, the vast majority (75%) want growth over safety, but this preference shifts dramatically so that only 17% prefer growth over safety at retirement. Also shown in the graph, those with another source of income, like a DB plan, opt for somewhat more growth, obviously because their other assets are safe.

The preferences in the table above can be used as proxies for preferred equity allocations along the glide path. The following graph shows these preferences in contrast to the Big 3 and SMART.



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SMART	95	90	85	79	74	69	63	52	35	10	10	10	10	10
Survey	97	93	89	86	82	79	75	66	40	17	13	13	13	13

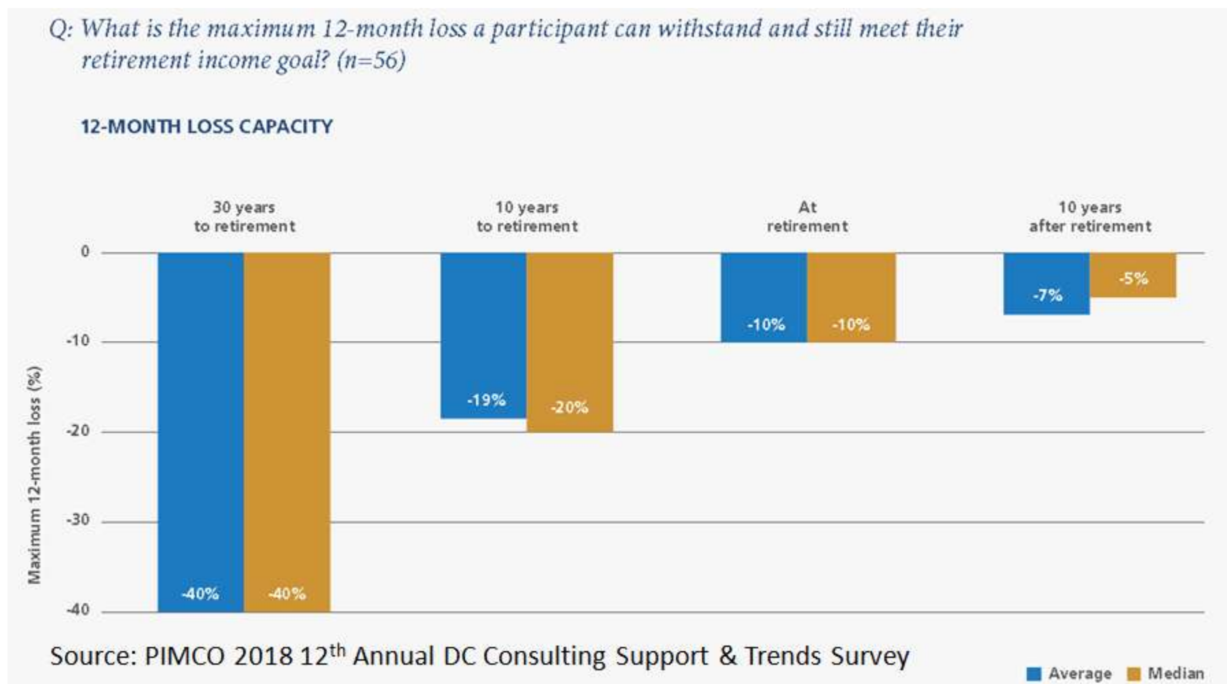
Beneficiary preferences are in line with Vanguard when participants are young but they move to the SMART index near the target date and beyond.

Reason 4: Consultants Want to Protect Beneficiaries in the Risk Zone

This reason is somewhat problematic because consultants say they want to protect beneficiaries from harm in the Risk Zone, but they choose TDFs that do not afford this protection. A reasonable explanation is that consultants are choosing TDFs to protect themselves rather than beneficiaries, so they opt for the procedural prudence that the Big 3 embodies.

Pacific Investment Management Company (PIMCO) has conducted a consultant survey entitled the "2018 12th Annual DC Consulting Support & Trends Survey", which they describe as follows: *Our 2018 survey captures data, trends and opinions from 77 consulting firms across the U.S., the highest number in the 12-year history of the survey. These firms advise over $4.4 trillion in U.S. DC assets, accounting for almost 60% of all U.S. DC assets.*

One of the questions that the survey addresses is loss avoidance at various dates along the TDF glide path. The responses are summarized in the next exhibit.



Source: PIMCO 2018 12th Annual DC Consulting Support & Trends Survey

Consultants want TDFs to defend against losses of 10% or more at the target date, and to become even more defensive beyond the target date, defending against losses of 5% or more. These goals argue for very conservative allocations, assuming that the objective is to have a low probability of the indicated loss. For example, a 10/90 stock/bond mix has a 95% probability of protecting against a 5% loss in a year.

Reason 5: There are 75 Million Baby Boomers in the Risk Zone

This reason is a different flavor of demographics that goes beyond individual plan workforces to the entire population of the U.S., so this discussion includes IRAs as well as target date funds. The average IRA is 55% in equities regardless of age.

Most Boomers are currently taking more risk than they should because they are in the Risk Zone, a time when they should protect their lifetimes of savings. Of course, if Boomers do sell a substantial part of their $30 trillion, it will cause a market correction, so you don't want to be the last one out the door. If they don't sell, the next meltdown (whenever it occurs) will create a public outcry like the world has never heard. It will take 20 years for Boomers to pass through the Risk Zone, so there's a good chance of a correction in that time span.

Can Society support tens of millions of Broke Boomers? Will it? If Boomers lose, we all lose.

Conclusion

Just because something is currently a certain way doesn't mean that it is the right way. If target date funds continue in the current way, beneficiaries are Cruisin' for a Bruisin'.