Selecting the Best Target Date Funds: Ten Tips for Advisors

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Target date funds (TDFs) are a big deal, the biggest deal in 401(k) land. Propelled by the Pension Protection Act of 2006, TDFs have grown from $20 Billion in 2006 to $1 Trillion today, and are forecast by Casey Quirk & Associates to quadruple to $4 Trillion over the next seven years. TDFs currently represent one-fourth of total 401(k) assets and are projected to grow to one-half by 2020.

Because TDFs have become such a big deal, fiduciaries should be particularly conscientious in their selection. Fiduciaries need to be concerned about the next 2008, because the next time the repercussions could be much uglier. In 2008 there was only $100 Billion in TDFs; now there's ten times that amount. The next market correction will probably bring lawsuits if near-dated TDFs suffer substantial losses as they did in 2008. The basis will be "You should have learned a lesson from 2008." According to Phillip Chiricotti, President of the Center for Due Diligence, "The tort bar is aggressive, creative and oftentimes at the forefront of changes in the law and legal industry. Indeed, few doubt that the new fee transparency regulations were significantly influenced by the onslaught of 401(k) fee litigation. "

Here are ten tips for fulfilling your fiduciary responsibility to seek the best target date funds.

1. Fiduciaries should vet their TDF selection even though most don't. 75% of TDF assets are with the Big 3 – Vanguard, T. Rowe Price, and Fidelity. Most believe "safety in numbers" is prudent, but "no misery' is preferred to "misery loves company." Fiduciaries are held to the duty of care, which means they must try to select the best, rather than what is convenient and familiar.

2. Qualified Default Investment Alternative (QDIA) status does not mean any QDIA will do. You need to try to select the best, based on your objectives rather than the objectives that fund companies are selling. TDFs should be bought, not sold. Throwing a dart at the QDIA dartboard is imprudent.

3. Fiduciaries should make capital preservation their primary TDF objective. It's what participants believe they are getting when they default – something safe.

4. Check TDF prospectuses and factsheets for statements of objectives. You will not find "replace pay and manage longevity risk" because these are hopes. An objective with no reasonable course of action is a "hope." These hopes are marketed but not committed to official documents. A typical TDF objective in prospectuses is "earn a return commensurate with the risk." Fiduciaries should seek solutions -- not products -- that are designed to achieve fiduciary objectives, rather than marketing hypes.

5. Risk at the target date has not changed in response to 2008 so the vulnerable remain in real peril as they approach retirement. It's a ticking time bomb.

6. Savings are the key to successful retirement, much more important than investments. Save enough, and protect it from loss.

7. The ideal TDF provides maximum diversification, especially at longer dates when there is more risk. As the target date nears, rigorous risk controls guard against losses. These services should be provided at the lowest cost possible and should employ a glide path design that is comprehensive and reliable. It is possible to provide these services for an all-inclusive fee below 40 basis points.

8. All TDFs are *de facto* "TO" funds because most participants withdraw their accounts when they retire. "TO" funds end at the target date, in contrast to "THROUGH" funds which are target death funds.

9. TDFs are good ideas that suffer from a misalignment of interests: participants bear the risk while fund companies enjoy the profits. Fund companies are incented to take risk because they get paid more, and because the performance horse race will probably be won by stocks in the long run. The problem is that participants are retiring every day, not the long run.

10. The most important distinction between TDFs is risk exposure (both stocks and bonds) at the target date. There is a wide dispersion of risk at the target date across TDFs, whereas all TDFs are similar at long dates. Risk near the target date is critical to lifestyle, i.e. standard of living in retirement. Here's why zero risk at the target date makes sense:

a. There is no fiduciary upside to taking risk at the target date. Only downside. The next 2008 will bring class action lawsuits to recover losses in near-dated funds.
b. Participants think they are safe, especially nearing retirement. They have no idea that they are exposed to substantial losses. They didn't know in 2008, and they certainly don't know today. Participants expect their employers to protect default investments.
c. Prior to the Pension Protection Act of 2006, default investments were cash. Has the Act changed the risk appetite of those nearing retirement? Surveys say no.
d. There is a "risk zone" spanning the 5 years preceding and following retirement during which lifestyles are at stake. Account balances are at their highest and a participant's ability to work longer &/or save more is limited. You only get to do this once; no do-overs. And most withdraw their accounts at the target date.
e. 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.

You might think that all TDFs have these traps, and you'd be almost right. There are a few that are almost trap free, and they're not hard to find. Just look beyond bundled service providers.

You might disagree with me. I hope not, but let's talk. If you'd like to talk face-to-face, I'll be presenting "Target Date Funds: The Other 401(k) Scandal" at the annual FPA conference on October 21 in Orlando, FL. I hope to see you there.

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