Custom Target Date Funds are a Big Fat Fraud

According to a recent PIMCO Study, "Custom Target Date Funds that can match demographics may enhance control and reduce costs. More than two in three consultants promote or support custom solutions. Plans as small as $200 million will likely go custom in the coming years. 51% of consultants believe that there is not enough choice in the market, or plan demographics are too unique for off-the-shelf solution."

Despite their growing popularity, custom TDFs are a big fat fraud, perpetrated to get consulting business. The fraud is that a glide path can actually be built to meet the unique needs of a diverse group of employees. And it's a fraud that is unwittingly supported by the Department of Labor. Advisors and the DoL have been duped. The claim of "matching demographics to their needs" is the fraud. The needs that are purported to be met are to replace pay and manage longevity risk. These simply can't be realistically achieved for a diverse group with wide ranges of salaries and savings. No glide path can meet these objectives.

Getting it right

There is a demographic that can be legitimately addressed by a target date fund. It's the one demographic that all defaulted participants have in common: lack of financial sophistication. The sole focus of all target date fund glide paths should be on those who default their investment decisions, since most assets in TDFs are there by default.

So what is the appropriate objective for the naïve? If 2008 taught us anything it's that TDF participants believe they are safe, especially as they near retirement. Participants in 2010 funds had no idea they could lose 30% of their savings, and they will never understand what happened. In other words, the risk tolerance of the unsophisticated is very low. **When you're walking in the dark every stumble is scary**. The naïve need to be protected, especially as they near the end their careers. This argues for conservatism near the target date – the more, the better.

In actual practice, "custom" TDF design follows a pre-canned glide path that has only a little to do with demographics. This cookie cutter is implemented with funds currently on the platform. Most cookie cutter glide paths have more than 50% in equities at the target date, with the balance in risky long term bonds. This article argues for very little risk at the target date in the cookie cutter designs, consisting mostyly of short term Treasuries and TIPS. That's what matters most.