Measuring the Risks and Rewards of Target Date Funds

Comparing "To" Funds to "Through" Funds

By Ronald J. Surz, CIMA®

Editor's Note: The opinions expressed in this article do not reflect the opinions of IMCA or the Investments & Wealth Monitor *editorial advisory board.*

The Department of Labor (DOL) 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, and they are in fact the most popular choice of QDIA. Importantly, advisors have been called upon to select TDFs, but unfortunately (or perhaps fortunately for the opportunistic) current offerings are not as good as they should be. Fiduciaries are settling for inferior product out of convenience, because their record keepers offer TDFs, or because they have been sold a "custom" glide path by an investment-only investment management firm.

TDFs are a reasonably good idea but have pathetic execution, at least so far. This is due in large part to the fact that most TDFs currently are designed to serve beneficiaries beyond the target date, to death. Such funds have come to be known as "through" funds, as opposed to "to" funds, which are designed to end at the target date. A secondary issue with "to" funds is the amount of equities that should be held at the target date; we believe zero is the correct answer for reasons to be explained later in this article. The year 2008 was disastrous for TDFs, with the typical 2010 fund losing 25 percent because the average 2010 fund was held 45 percent in equities. (Year 2010 funds are intended for those retiring between 2005 and 2015.)

We should have learned a lesson from 2008, but little has changed other than it is likely that the Securities and Exchange Commission (SEC) and DOL will require fuller disclosure, especially about the meaning of the date in target date fund names. (Perhaps "through" funds will have to be called "target death" funds.) With the recovery in 2009, some have begun to argue that even "to" funds should have higher, rather than lower, equity allocations at target date because participants will be richer. For example, Basu (2009) argues that a glide path that increases equity exposure through time dominates the traditional glide path, which has decreasing equity exposures. According to Basu, this "contrarian" path delivers greater ending-wealth 90 percent of the time with about the same risk. The flaw in this approach is that risk is measured without regard to account size, so losing 10 percent of a \$10 portfolio early on in the glide path is no different than losing \$100,000 on a \$1-million portfolio as the glide path matures. We correct this mistake in this article and reach a totally different conclusion. After all, who would advise their clients to be entirely in equities as they enter retirement?

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Comparing the Glide Paths of "To" and "Through" Funds

Here we compare and contrast the risks and rewards of "to"' versus "through" funds. Because "through" funds are designed to last a lifetime, they are somewhat aggressive at target date. Importantly, most if not all participants do not leave their savings with the plan when they terminate employment, so practice defies the objective of "through" funds. No one stays in the plan to the grave.

Fiduciaries also should consider "to" funds, if for no other reason than "to" funds expect participants to withdraw at the target date, as is the practice. Plan sponsors are the only ones with the fiduciary responsibility for selecting and monitoring TDFs. The glide paths of "to" funds are designed to end at the target date, requiring the plan participant to do something quite extraordinary—think and act. Why? Because the target date fund has done its job: It has brought the investor "to" the target date and now the investor needs to assess what type of portfolio might best meet his or her specific needs at that point. In this article, we end the "to" fund example at zero in equities in keeping with the Safe Landing Glide Path™, designed and maintained by my firm. Ending the glide path entirely in safe investments protects the investor during the transition from accumulation to distribution, that is, while the investor is deciding on retirement investments.

There's a good chance that plan participants and sponsors thought they were buying "to" funds, if for no other reason than the date in the fund name. Certainly those who have purchased target date funds for college tuition believe they are buying "to" funds. The perspective of a "to" fund provider is that a well-constructed generic glide path can serve the majority during their working lives, but retirement is far too complex for a one-size-fits-all solution. It further presumes that plan participants can in fact make their own decisions about matters that affect the rest of their lives.

Figure 1 compares the glide paths of these two approaches. The "through" approach is exemplified by the peer industry average allocation through time. The "to" approach is represented by the Safe Landing Glide Path.

As you can see, the two paths are quite similar at distant dates but diverge as the target date approaches.

FIGURE 1: TO SAFE LANDING GLIDE PATH™ COMPARED TO THROUGH (PEER)

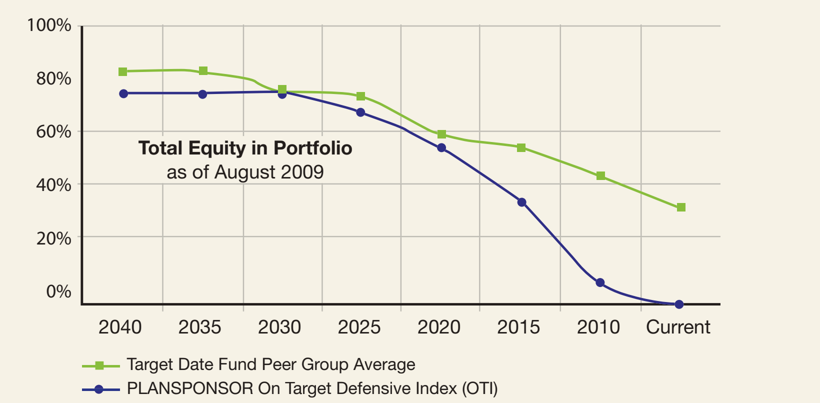


FIGURE 2: TO VERSUS THROUGH GLIDE PATH COMPARISONS, 1926–2008 (44 40-YEAR PERIODS)

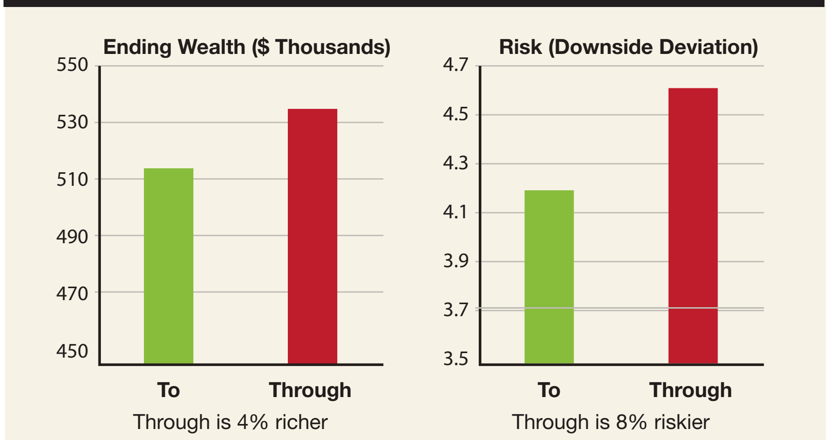
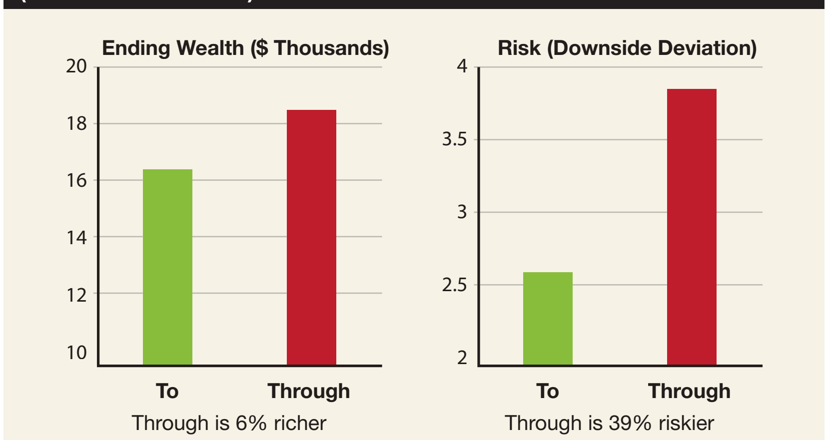


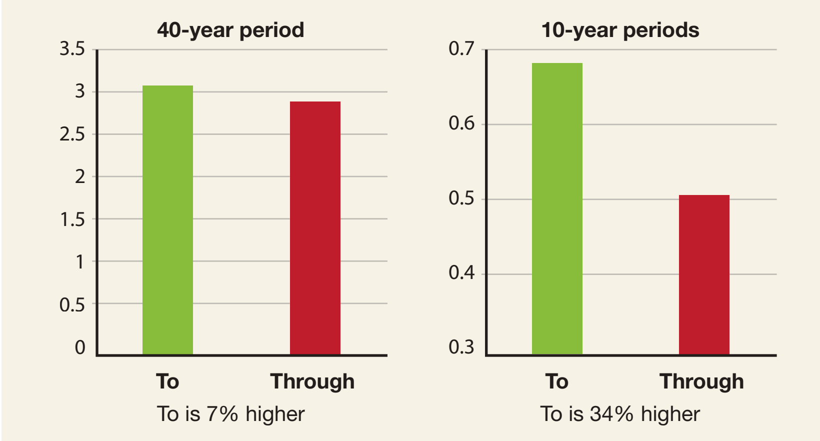
FIGURE 3: TO VERSUS THROUGH GLIDE PATH COMPARISONS, 1926–2008 (74 10-YEAR PERIODS)



Accurate Measurements of Target Date Fund Risk and Reward

A logical question for fiduciaries is, "What does this do to risk and reward of these paths." To answer this question, we have measured ending wealth and risk for all 40-year glide paths going back to 1926. There are 44 such 40-year paths ending in calendar years. It is assumed that the investor contributes $1,000 initially and increases this $1,000 by 3 percent per year, so the contribution is

FIGURE 4: REWARD-TO-RISK RATIOS, 1926–2008



$1,030 in the 2nd year, $1,061 in the 3rd year, etc. The risk measure is dollar-weighted downside deviation, which we call "risk of ruin." The rationale for this measure of risk is provided in Surz (2009). Figure 2 summarizes the results.

The two approaches are quite similar, with the "through" path delivering somewhat greater wealth but with more risk—4 percent more wealth on average with 8 percent more risk. But this is for the entire 40 years, where the two paths are quite similar for all but the final 10 years, at which point the "to" path diverges to zero while the "through" path ends at 35 percent in equities at the target date. This difference in the final 10 ten years is critical.

The transition from the pre-retirement accumulation phase to the post-retirement distribution phase is the most critical time for investor wealth and well-being because account balances are at their highest. Many participants increase contributions during the last 10 years of employment, to catch up or enhance. Anything that jeopardizes asset value during the five years on either side of retirement is a risk that plan participants should not be taking. Plan participants and sponsors should recognize the need to protect asset value during this critical transition phase. Witness the unfortunate calamity that befell 2010 fund investors in 2008.

Accordingly, we've conducted a similar analysis focused on just the final 10 years of the glide path. Figure 3 summarizes 74 such 10-year periods.

Now we see a huge difference in risk, with the "through" approach taking 39 percent more risk than the "to" path while delivering only marginally more wealth.

Another way to compare risk and reward is by calculating the ratio of ending wealth to downside risk, as shown in figure 4.

As you can see, the reward-to-risk is about the same for the complete 40-year glide path, but "to" funds dominate over the shorter 10-year period, which will be the case with the critical final 10 years of the path. So now you know the risk and reward considerations in your choice between "to" and "through."

Conclusion

Fiduciaries—namely plan sponsors and their advisors—need to recognize that they are responsible for choosing good TDFs. The safe harbor of a QDIA is very flimsy fiduciary insulation. Until now, the "through" solution has been sold because it provides the fund provider with an extended revenue stream and the higher fees associated with high equity allocations. Consequently, "through" funds appear to be the only game in town, but this is simply not true—there are indeed "to" funds. Choice comes as no surprise in this relatively new product offering. The good news is that one of the critical choices is straightforward: "through" or "to." Less is more.

Fiduciaries have the power and responsibility to require what is best for plan beneficiaries. It's all about the beneficiaries. Beneficiaries are best served by properly constructed "to" funds that follow something like the Safe Landing Glide Path™ because prudence argues for safety as the target date approaches. It's helpful to remember that before TDFs were declared QDIAs the popular default choice was stable value, which emphasizes safety over growth. "Through" funds swing the pendulum too far in the opposite direction.

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