The Hidden Risk in Target Date Funds

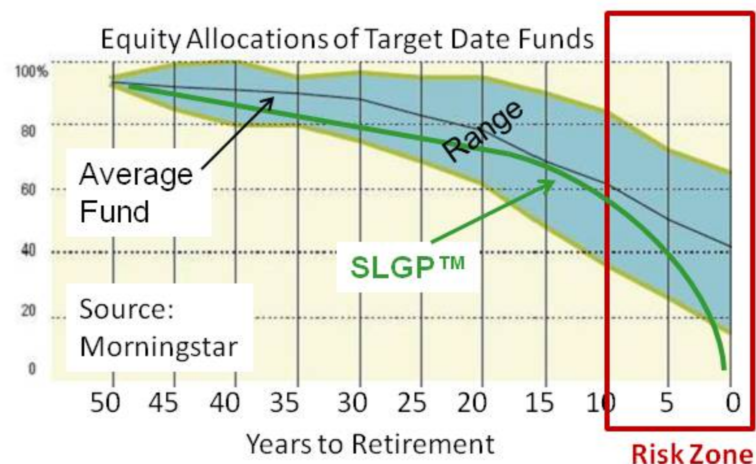
By Ron Surz
April 27, 2010

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Choosing the appropriate target date fund (TDF) for an investor is not easy, given the large number of products in the marketplace and the lack of tools to easily compare those offerings. That choice, however, is made a lot easier if one focuses on the component of TDFs where investors are exposed to the greatest risk – what I call the "risk zone."

The risk zone is the five to ten years before and after retirement. During this period, investors are least able to tolerate adverse market conditions, when significant dollar losses in their portfolio can be compensated for only by reducing their standard of living.

The risk zone is also critical from the plan sponsor's perspective. Older, more senior, employees are more likely to sue, or at least make their voices heard, than are younger employees with smaller account balances. Employers should fear the risk zone for both its litigation threat and its importance to employee morale. Fiduciaries need to set objectives for the risk zone, and safety first should be the order of the day.



Glide paths of TDFs differ markedly as they approach and enter the risk zone, and this divergence creates a hidden risk for investors. Without understanding the implications of an excessively risky glide path in the risk zone, investors may face painful choices in their retirement. I have

© Copyright 2010, Advisor Perspectives, Inc. All rights reserved.

created a simple metric, which I explain below, that can help advisors and investors choose the right TDF.

We need to be especially diligent and protective during the risk zone, but how do we measure and evaluate safety in this critical period? As shown in the graph on the right, TDFs have a wide range of equity exposures in the risk zone; they disagree about the appropriate level of risk. The range of equity allocations widens as retirement approaches.

The Safe Landing Glide Path™ (SLGP) is also shown in the graph. The SLGP™ is designed to achieve two common sense objectives:

1. Build a portfolio that, at retirement, delivers to each participant, at a minimum, his or her accumulated contributions plus inflation.

2. Grow assets as much as possible without jeopardizing the first objective.

The safety first objective necessitates an end point that is mostly in inflation-protected assets, namely TIPS and T-Bills.

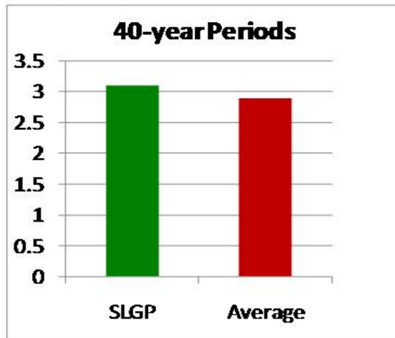
Let's consider the risk and reward trade-offs for varying equity exposures in the risk zone. Since investors should be concerned with lifestyle risk, I define risk as a dollar loss rather than percentage loss. Losing 10% of a one-dollar portfolio is significantly less painful than losing 10% of a million-dollar savings account.

Lifestyle in retirement depends on money, not percentages. Accordingly, I have measured ending wealth and risk for all 40-year glide paths from 1926 through 2009. There are 44 such 40-year paths ending in calendar years. I assumed that the investor contributes $1,000 initially and increases this $1,000 by 3% per year, roughly equal to the historical inflation rate. I measured risk as the dollar-weighted downside deviation, and "reward" as the dollar growth. I also analyzed just the last 10 years of the glide path to focus on the risk zone. There are 74 such 10-year periods.

I compared the reward (dollar growth) and risk (of dollar loss) of the SLGP target date fund to that of the average TDF, shown as the middle line in the graph above. The glide path of the SLGP™ ends almost entirely in safe assets, whereas the typical TDF ends with 40% in equities because it is a "through" fund designed to continue beyond the retirement date, so it is substantially riskier in the risk zone. The results for the ratio of reward (ending wealth) to risk (dollar-weighted downside deviation) are as follows:

© Copyright 2010, Advisor Perspectives, Inc. All rights reserved.

Reward-to-Risk Ratios 1926-2008



SLGP™ is 7% Higher

SLGP™ is 34% Higher

The SLGP™ unsurprisingly delivers superior reward-to-risk in the risk zone, defined as the last 10 years before retirement. Somewhat surprisingly, however, the reward-to-risk ratios are about the same for the entire 40 years prior to retirement, primarily because the glide paths of the two approaches are similar for the first 25 of those 40 years. When viewed over the continuum of their lives, TDFs look deceptively similar; their hidden risk is only visible when one examines the risk zone.

Enlightened advisors should focus on the risk zone in their TDF selection. Most TDFs provide similar asset allocations prior to the risk zone, and then diverge widely in their equity exposures as the target date nears. Most TDFs view the target date as a speed bump on the highway of life, ignoring the risk zone altogether. During this critical period, TDFs demonstrate their mettle, protecting or not. “Safety first” is the right choice as the target date nears because lifestyles are at stake. Advisors can help protect their clients from lifestyle risk by choosing the right TDF.

Endnote

For an entertaining and informative description of the risk zone, and an explanation of why spending is harder than saving, please see the video of Prof. Moshe Milevski, York University, at return sequence risk

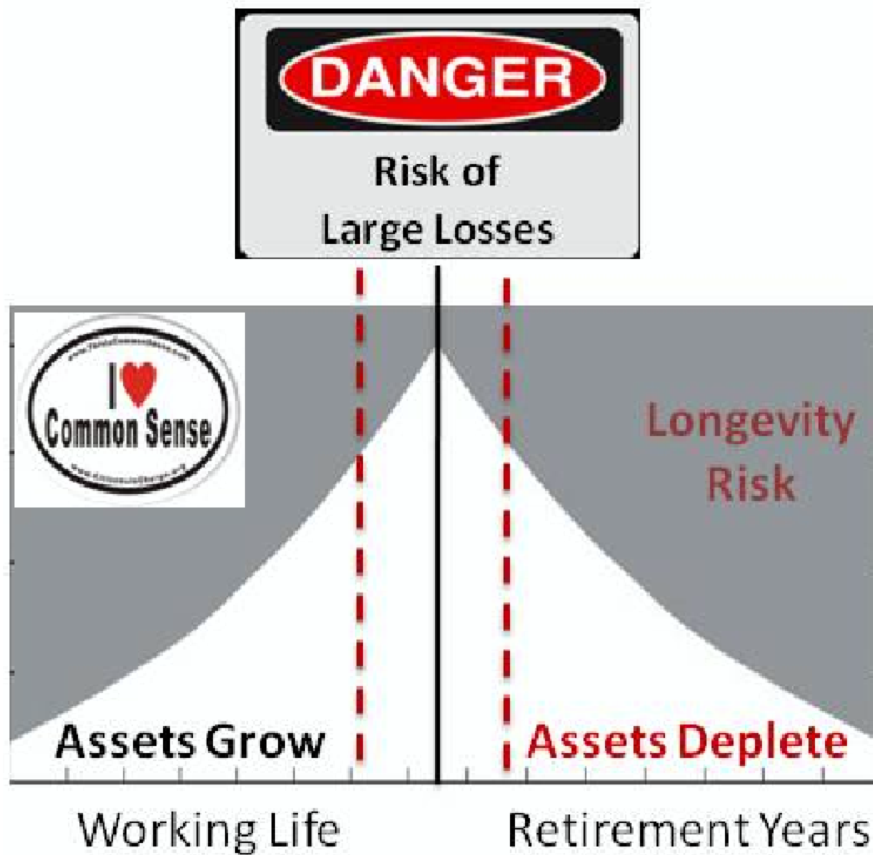
Ron Surz is President of Target Date Solutions, 949-488-8339
Ron@TargetDateSolutions.com

© Copyright 2010, Advisor Perspectives, Inc. All rights reserved.

ADVISOR PERSPECTIVES

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php



© Copyright 2010, Advisor Perspectives, Inc. All rights reserved.