The Human Face of Target Date Fund Glidepaths: A Rebuttal to Arnott's "Glidepath Illusion…"

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In the Fall, 2013 issue of the ***Journal of Retirement*** Robert Arnott *et al* question the wisdom of target date fund glidepaths that reduce equity exposure through time, arguing that a reverse approach with increasing equities delivers greater ending wealth, even at the lower tail of the wealth distribution (see [Arnott, 2013]). Arnott shocks us with an apparent recommendation for a glidepath with increasing risk through time. After all, who would advise their 70-year-old client to hold 80% in stocks and 20% in bonds?

The fact of the matter is that glidepaths really don't matter much, regardless of their pattern up or down. Saving enough is what matters most; it's the most important step on the path to a comfortable retirement. No glidepath can compensate for inadequate savings. And the second most important step on the path to a comfortable retirement is protection – don't lose your savings. Please see Save and Protect for more details. This protection is most critical as retirement nears because savings are at their highest and lifestyles are at stake.

The simulations in the Arnott article are not new. The recommendation for an inverse glidepath was first introduced by two Australian professors in 2009. See [Drew, 2009]. I responded to the Australian article in [Surz, 2009] , and my response is just as valid for the Arnott version.

Here's the economic, behavioral and emotional reality of glidepaths. We each have only one life path, not the thousands that a computer can simulate. And we each prepare differently for retirement. As noted above, the most important aspect of our preparedness is savings. Some of us will save "enough" and some of us won't. Those who haven't saved enough will redefine "enough" – they'll reduce their standard of living. Regardless of our savings history, we all develop a plan as retirement approaches. Some of us see yachts in retirement while others see trailer parks. Either way, a plan is a plan. Disruptions to our planned lifestyle take a huge toll, and can lead to deep depression and physical calamities, like drug and alcohol abuse.

That's the human side of glidepaths – safety at retirement makes a big difference. Despite the subsequent recovery, 2008 was devastating to those in and near retirement at that time; the typical 2010 fund lost 25% in 2008. Reports show that most TDF participants withdraw their savings at retirement so they did not enjoy the recovery unless they rolled over their savings into stocks, an unlikely choice in light of the 2008 debacle. Bear in mind that there was only a couple hundred $Billion in TDFs in 2008, whereas today the number is close to one $Trillion. The next 2008 will be substantially more devastating for TDF participants.

Retirees cannot recover from investment losses the way they could while working. Their only course of action is to lower their standard of living, which takes an emotional and physical toll, as well as burdens our society which thankfully cares for its elderly.

So how safe is safe? The common practice is to increase bond exposure as the target date nears, but long term bonds are not safe in this economic environment. The right "Safe" is short term Treasure bills and Treasury Inflation-Protected Securities (TIPS). Note that this safety need not apply to retirement years. Rather it's critical to the transition from working life to retirement. Choices in retirement can and should be unique and individualized. For example Pfau and Kitces argue for a U-shaped lifetime glidepath, decreasing in risk through our working life and then increasing in retirement.

Arnott does not actually recommend an inverse glide path. It's simply a ploy to get our attention, and it worked. His article and related video have received wide interest. He's simply saying target date funds could, and should, be better. I agree. TDFs are becoming increasingly important, and currently hold about $1 Trillion. The primary benefits are diversification and risk control, both of which could be substantially improved.

Arnott's recommended improvement is stated in the conclusion as follows: *"A more sophisticated solution might add a whole spectrum of additional asset classes—many offering more yield or higher growth prospects (or both) than the classic glidepath strategy—and could incorporate tactical disciplines, to avoid the pitfalls of mechanistically trading into markets at near-record low yields."* This is a recommendation to use an expanded list of passively managed asset classes, with fundamental smart beta weights, and to time allocations to these asset classes. TDFs are selected by fiduciaries who need to be smarter, so this recommendation is worthy of consideration, plus there's much more, as I describe in the Fiduciary Guide to Selecting Target Date Funds.

I'm writing this from the perspective of a semi-retired 69-year-old pension consulting veteran. I am personally one of the many human faces of glidepaths, so I take this topic very seriously.

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